Supreme Court, U.S.
FILED

97 966 DEC 10 1997

OFFICE OF THE CLERK

No. 97-

In The

SUPREME COURT OF THE UNITED STATES

October Term, 1997

CATERPILLAR INC.,

Petitioner,

v.

COMMISSIONER OF REVENUE,

Respondent.

On Petition for Writ of Certiorari to the United States Supreme Court of Minnesota

PETITION FOR A WRIT OF CERTIORARI

Of Counsel:

DANIEL J. SCHLICKSUP
CATERPILLAR INC.
100 N.E. Adams Street
Peoria, Illinois 61629
(309) 675-8039

DAVID R. BRENNAN
FAEGRE & BENSON LLP
2200 Norwest Center
90 South Seventh Street
Minneapolis, Minnesota 55402
(612) 336-3000

JEROME B. LIBIN
(Counsel of Record)
WALTER HELLERSTEIN
TIMOTHY H. GILLIS

SUTHERLAND, ASBILL
& BRENNAN LLP
1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-0100

Counsel for Petitioner

December 10, 1997

101 pp.

QUESTIONS PRESENTED

1. Whether Minnesota's "water's edge combined reporting" method of taxing corporate income facially discriminates against foreign commerce in violation of the Foreign Commerce Clause, by taxing interest and royalties received from unitary foreign subsidiaries less favorably than interest and royalties received from unitary domestic subsidiaries?

2. Whether the Minnesota Supreme Court adopted an erroneous test for establishing impermissible facial discrimination against foreign commerce with respect to specific items of income under "water's edge combined reporting" by requiring the taxpayer to show that its overall tax burden is heavier under the "water's edge" method than it would be under a hypothetical "worldwide combined reporting" method not adopted by Minnesota?

RULE 29.6 STATEMENT

Petitioner is the parent company of a group of domestic and foreign subsidiaries. The subsidiaries of petitioner, other than wholly-owned subsidiaries, are listed in the Appendix at pages 66a-68a.

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No. 97-

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1997

CATERPILLAR INC.,

Petitioner,

v.

COMMISSIONER OF REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE
SUPREME COURT OF MINNESOTA

OPINIONS BELOW

The opinion of the Supreme Court of Minnesota is reported at 568 N.W. 2d 695 (Minn. 1997). The court's opinion is reproduced in the Appendix at pages 1a-15a. The order and memorandum of the Minnesota Tax Court have not been reported. They are reproduced in the Appendix at pages 16a-23a.

JURISDICTION

The judgment of the Supreme Court of Minnesota was entered on September 11, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. sec. 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, art. I, sec. 8, cl. 3 provides: The Congress shall have power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

Relevant portions of Sections 290.17, 290.19 and 290.34 of the Minnesota Statutes are set forth in the Appendix at pages 38a-45a, respectively.

STATEMENT

A. Relevant Facts

Petitioner is an Illinois domiciliary corporation. It is the parent company of a group of domestic and foreign subsidiaries engaged in the business of manufacturing and selling engines and earth-moving equipment throughout the United States and in numerous foreign countries. Petitioner and its subsidiaries are engaged in a single unitary business.[1/]

[1/] Respondent has stipulated that during the years here involved, 1979 through 1987, petitioner and at least certain of its subsidiaries (both foreign and domestic) were so engaged. The Illinois Supreme Court has held that the operations of petitioner and its subsidiaries are a "classic illustration of a unitary business." *Caterpillar Tractor Co. v. Lenckos*, 417 N.E. 2d 1343, 1351 (Ill. 1981).

A "unitary business" is one that is characterized by functional integration, centralization of management and economies of scale, and by a "flow of value" between the various units of the business. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 783 (1992) and cases there cited.

Petitioner licenses its trademarks and technology to its unitary foreign subsidiaries in return for royalties. Petitioner also provides loans to its unitary foreign subsidiaries and receives interest payments from those subsidiaries. Such royalties and interest payments are the items of income at issue in the instant case.[2/]

Petitioner and two domestic subsidiaries were the only members of the unitary group that actually conducted business in Minnesota during the years involved. Their activities in Minnesota were very limited relative to the activities of the entire unitary group.

B. Minnesota's Taxing Scheme

Since 1982, Minnesota law has required any corporation doing business in the state as a member of a unitary business group to file a corporate excise tax return under the "water's edge combined reporting" method of taxing corporate income.

Under a "water's edge combined reporting" regime, a state generally seeks to include in the group of unitary corporations that must file a combined report only those companies that conduct their activities within the United States (i.e., the combined group is limited to those entities within "the water's edge"). This method may be contrasted both with "worldwide combined reporting," under which all companies in the unitary group -- foreign as well as domestic -- are included in the combined report, and with "separate company reporting," under

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[2/] Respondent has stipulated that at least certain unitary foreign subsidiaries paid interest and royalties to petitioner during the years involved.

which any company in the unitary group doing business in the taxing state files its own separate return.[3/]

Under Minnesota's "water's edge combined reporting" system, those unitary domestic companies conducting business in Minnesota file a single combined tax return that reports the total income earned from all sources *by the domestic parent company and all unitary domestic subsidiaries in the group,* including those that do not conduct business in Minnesota. Intragroup transactions between such "water's edge" companies, including any interest and royalty payments made by a domestic subsidiary to its parent, are "eliminated" in the combined income calculations (i.e., treated as if they had not been made). The "water's edge" group's combined income as so calculated becomes the Minnesota tax base.

A portion of the tax base as thus determined is then apportioned to Minnesota by application of the standard three-factor apportionment formula utilized in many States. The numerators of the apportionment formula are the Minnesota property, payroll and sales figures of those unitary domestic companies doing business in the State. Such amounts reflect the in-state business activity of those companies. The denominators of the formula are the total property, payroll and

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[3/] For the years 1979-1981, Minnesota did not require or permit combined reporting. Instead, Minnesota required each corporation subject to Minnesota tax to file a separate return. However, there was an exception if a corporation elected to carry a net operating loss from a combined reporting year (*i.e.*, for years 1982 and following) back to a separate reporting year. Petitioner carried net operating losses back from combined reporting years to its 1979-1981 separate reporting years and therefore recomputed its tax for those years "as if" it had filed on a combined reporting basis.

sales of the entire "water's edge" group. Those amounts reflect the total business activity of the entire group conducted everywhere.

The resulting fractions are weighted and averaged to determine the final apportionment fraction. That fraction is then applied against the tax base to determine the amount of "water's edge" combined income properly apportionable to Minnesota and taxable by it.[4/]

Unitary foreign subsidiaries are not included in Minnesota's "water's edge" combined report. Intragroup payments made by such foreign subsidiaries, including interest and royalties paid to their domestic parent, are not eliminated and restored to the subsidiaries, but instead are included in the Minnesota tax base -- as income of the parent. However, no portion of the property, payroll or sales amounts of a unitary foreign subsidiary making such payments is included in the denominators of the Minnesota apportionment formula.

C. Similar State Taxing Schemes

In addition to Minnesota, at least 19 other States either require or permit the use of "water's edge combined reporting," or some variation of it, in taxing the income of a unitary business.[5/]

[4/] The relevant Minnesota statutes, sections 290.17, 290.19 and 290.34, are set forth at App. 38a-45a.

[5/] Alaska, Arizona, California, Colorado, Florida, Idaho, Illinois, Indiana, Kansas, Kentucky, Maine, Montana, Nebraska, New Hampshire, New Mexico, North Dakota, Oregon, Utah, and Virginia. See App. 46a-48a.

Some versions of "water's edge combined reporting" exclude domestic

(continued...)

D. Proceedings Below

Petitioner filed amended tax returns for the years in question, claiming a refund of approximately $385,000 in taxes based on the exclusion from its income of interest and royalties received from its unitary foreign subsidiaries. Respondent denied the refunds. Petitioner then challenged the constitutionality of the State's "water's edge" taxing scheme in the Minnesota Tax Court, claiming that it facially discriminated against foreign commerce in violation of the Foreign Commerce Clause, both in the manner in which such interest and royalty payments were reflected in the tax base and in the composition of the State's apportionment formula.

Petitioner relied primarily on this Court's decision in *Kraft General Foods, Inc.* v. *Iowa Dep't of Rev. & Fin.*, 505 U.S. 71 (1992). In *Kraft*, this Court, speaking through Justice Stevens, struck down, as a facially discriminatory violation of the Foreign Commerce Clause, Iowa's "separate reporting" tax regime under which dividends received from unitary foreign subsidiaries were included in the Iowa tax base while dividends received from unitary domestic subsidiaries were excluded from the tax base.

5/ (...continued)
corporations that derive at least 80 percent of their income from foreign sources. Some versions include foreign corporations if at least 20 percent of their apportionment factors are within the United States or at least 20 percent of their business activity is within the United States. (Such companies are referred to as "80-20 companies"). Minnesota uses the "domestic combination" version, which includes all domestic corporations in the group.

The Minnesota Tax Court held that the "water's edge combined reporting" method of taxation did not violate the Foreign Commerce Clause. Citing footnote 23 in *Kraft*, the Tax Court compared the taxation of interest and royalties received from a unitary foreign subsidiary with the taxation of similar payments received, not from a unitary domestic subsidiary, but from an unrelated, nonunitary domestic third party. Since payments received from those two entities would be taxed in the same manner under Minnesota (i.e., full inclusion in the tax base as income of the parent; no payor factors in the apportionment formula), the Tax Court found no impermissible discrimination in the Minnesota scheme.[6/]

[6/] Footnote 23 in *Kraft*, 505 U.S. at 80 n.23, reads as follows:

> If one were to compare the aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent.
>
> In considering claims of discriminatory taxation under the Commerce Clause, however, it is necessary to compare the taxpayers who are "most similarly situated." *Halliburton Oil Well Cementing Co.* v. *Reily*, 373 U.S. 64, 71 (1963). A corporation with a subsidiary doing business in Iowa is not situated similarly to a corporation with a subsidiary doing business abroad. In the former case, the Iowa operations of the subsidiary provide an independent basis for taxation not present in the case of the foreign subsidiary. A more appropriate comparison is between corporations whose subsidiaries do not do business in Iowa.

The Minnesota Supreme Court affirmed. After stating that the Tax Court's comparison might well be correct, the Minnesota Supreme Court also held that there was no facial discrimination even if the proper comparison were between payments made by a unitary foreign subsidiary and a unitary domestic subsidiary. Referring again to footnote 23 in *Kraft*, the Minnesota Supreme Court reasoned that foreign commerce is not treated less favorably under the Minnesota system because a unitary domestic subsidiary has its entire income included in the Minnesota tax base, while only the interest and royalty payments made by a unitary foreign subsidiary are so included. The court also stated in a footnote that because interest and royalty payments were expenses of the foreign subsidiaries, it would be inappropriate to include any portion of the foreign subsidiaries' property, payroll and sales factors in the denominators of the group's apportionment formula. The court further held that because petitioner failed to show that its overall tax burden under "water's edge combined reporting" was greater than it would have been under "worldwide combined reporting," it could not be heard to complain about the tax treatment of interest and royalties under the "water's edge" method.

REASONS FOR GRANTING THE WRIT

The instant case presents a fundamental question of considerable importance under the Foreign Commerce Clause -- whether, in the context of a "water's edge combined reporting" tax regime, a State impermissibly discriminates against foreign commerce by taxing interest and royalties received from unitary foreign subsidiaries doing business abroad less favorably than identical payments received from unitary domestic subsidiaries doing business in the United

States. Previous decisions of this Court in this area have considered state income tax regimes that required either "separate reporting" or "worldwide combined reporting."[2/] No decision of this Court thus far has addressed the scope and limits of "water's edge combined reporting" under the Foreign Commerce Clause.

The specific issue here presented arises directly out of this Court's decision in *Kraft*, *supra*, which involved the taxation of unitary foreign subsidiary dividends. Since *Kraft* was decided, several state courts, including the court below, have considered facial discrimination claims under a "water's edge combined reporting" tax regime. In each of those cases, the state court has misinterpreted and improperly relied upon this Court's footnote 23 in *Kraft* to reach a result contrary to *Kraft*. *See, e.g., E.I. Du Pont de Nemours & Co.* v. *State Tax Assessor*, 675 A.2d 82 (Me. 1996) (holding that, with respect to foreign subsidiary dividends, Maine's "water's edge combined reporting" method avoids the discrimination invalidated by this Court in *Kraft*); *In re Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993) (concluding that, insofar as foreign

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2/ *See, e.g., Kraft General Foods, Inc.* v. *Iowa Dep't of Rev. & Fin.*, 505 U.S. 71 (1992) (invalidating "separate reporting" tax regime that taxed dividends received from unitary foreign subsidiaries but not from unitary domestic subsidiaries); *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) (upholding "separate reporting" tax regime that included dividends received from unitary foreign subsidiaries in domestic parent's apportionable tax base in nondomiciliary state); *Container Corp. of America* v. *Franchise Tax Bd.*, 463 U.S. 159 (1983) (upholding "worldwide combined reporting" regime as applied to unitary group with domestic parent); *Barclays Bank PLC* v. *Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994) (upholding "worldwide combined reporting" regime as applied to unitary group with foreign parent).

subsidiary dividends are concerned, Kansas's "water's edge combined reporting" method precludes a determination of facial discrimination such as that found in *Kraft*); compare *Conoco, Inc.* v. *Taxation & Rev. Dep't.*, 931 P.2d 730 (N.M. 1996), *cert. denied*, 117 S. Ct. 2497 (1997) (finding discrimination under New Mexico's "separate reporting" regime).

Petitioner itself has been a party to cases in three other states raising the same issue as that here presented. In New Hampshire, the Superior Court concluded that footnote 23 in *Kraft* "states that the outcome would have been different had Iowa employed a combined apportionment method." (Slip op. 8; App. 57a.) The court found no facial discrimination under New Hampshire's "water's edge" system because the entire income of the unitary domestic subsidiaries was included in the tax base. *Caterpillar Inc.* v. *New Hamp. Dep't of Rev. Admin.*, No. 93-E-609, slip op. (N.H. Superior Ct. October 10, 1997) (appeal pending). In Illinois, the Appellate Court concluded that there was no discrimination against foreign commerce because the total income of the domestic subsidiaries was included in the tax base. It also agreed with the Minnesota Tax Court's view that in a "water's edge" context, unitary foreign subsidiaries are more similar to unrelated, nonunitary domestic third parties than to unitary domestic subsidiaries. *Caterpillar Fin. Serv. Corp.* v. *Whitley*, 680 N.E.2d 1082 (Ill. App. Ct.), *appeal denied*, 174 Ill. 2d 556 (1997). In Florida, however, the Circuit Court issued an Order Deferring Ruling expressing its view that the Florida scheme had "a potential constitutional defect." The court urged the parties to settle the case, which they did. *Caterpillar Inc.* v. *State of Florida*, No. 95-1290 (Fla. Cir. Ct. May 2, 1996) (unpublished Order; App. 61a-65a.)

Like most of the other state courts referred to above, the Minnesota Supreme Court has erroneously upheld a facially discriminatory tax provision on the misguided ground that footnote 23 in *Kraft* has effectively precluded a finding of facial discrimination under the "water's edge" method. It is apparent from these decisions that there is considerable confusion at the state level regarding the meaning of footnote 23 in *Kraft*, and also regarding the proper test to be applied in determining impermissible discrimination under the Foreign Commerce Clause in a "water's edge combined reporting" context.

While the instant case involves Minnesota's tax regime, at least 19 other States also utilize some form of "water's edge combined reporting."[8/] The issues raised by the instant case will thus have a broad impact on U.S. multinational corporations that conduct a global unitary business and that, like petitioner, lend funds and license technology or trademarks to various foreign subsidiaries as part of their unitary operations. Given the substantial number of States that employ "water's edge combined reporting," the considerable number of taxpayers affected by the issues here presented and the fundamental misunderstanding of *Kraft* evidenced by several state courts, including the court below, guidance from this Court is not only fully warranted but clearly needed at this time.

8/ *See* note 5, *supra*.

I. REGARDLESS OF ITS TAXING SCHEME, A STATE CANNOT PERMISSIBLY TAX PAYMENTS RECEIVED FROM UNITARY FOREIGN SUBSIDIARIES LESS FAVORABLY THAN IDENTICAL PAYMENTS RECEIVED FROM UNITARY DOMESTIC SUBSIDIARIES

A. The Discrimination Here

Like *Kraft*, the instant case involves the meaning of the "nondiscrimination" requirement of this Court's Foreign Commerce Clause jurisprudence.[9/] Like *Kraft*, the instant case also involves a claim of facial discrimination against foreign commerce. *Kraft* concerned facial discrimination in the *tax base* under a "separate reporting" tax regime. The instant case concerns facial discrimination in either the *tax base* or the *apportionment formula* under a "water's edge combined reporting" tax regime.

Though the statutory scheme in the instant case is more complex than the scheme involved in *Kraft*, it is indisputable that the Minnesota system treats interest and royalty payments received from foreign subsidiaries doing business abroad less favorably than interest and royalty payments received from domestic subsidiaries doing business in the United States.[10/]

[9/] See *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 444-45 (1979).

[10/] Petitioner does not here challenge Minnesota's adoption of a "water's edge combined reporting" method, nor does it argue that either "separate reporting" or "worldwide combined reporting" is constitutionally mandated. Rather, petitioner here challenges one aspect of "water's edge combined reporting" -- namely, the discriminatory manner in which Minnesota taxes

(continued...)

1. Domestic Subsidiary Payments

Minnesota requires interest and royalty payments made to the parent company by a unitary domestic subsidiary to be *eliminated* from the parent's income and the subsidiary's deductions and shifted back to the subsidiary as if they had not been made. The aggregate amount of such payments is thus included in the water's edge group's combined income -- as restored income of the subsidiary.

In addition, the domestic subsidiary's property, payroll and sales factors are fully included in the denominators (and, where appropriate, in the numerators) of the group's apportionment formula. With respect to those domestic subsidiaries that do not conduct business in Minnesota, the inclusion of their property, payroll and sales factors in the formula denominators serves the proper function of apportioning away from Minnesota the unitary income earned outside of Minnesota by those subsidiaries.[11/] In that fashion, "water's edge combined reporting" satisfies the constitutional requirement that Minnesota not tax income earned by the domestic subsidiaries outside the state. *See, e.g.*, *Container Corp., supra*, 463 U.S. at 164 (a State may not "tax value earned outside its borders").

10/ (...continued)
interest and royalty payments received from foreign and domestic subsidiaries of a unitary group.

11/ The larger the denominators in the apportionment formula, the smaller the resulting apportionment fraction, and, accordingly, the smaller the portion of the tax base that will be apportioned to the taxing state.

2. Foreign Subsidiary Payments

Payments of interest and royalties made by a unitary foreign subsidiary to the parent company are *not eliminated* from the parent's income and are *not shifted back* as restored income of the subsidiary. Rather, such payments are included in the water's edge group's combined income -- as income of the parent.

Moreover, in sharp contrast to the inclusion of the domestic subsidiary's property, payroll and sales factors in the group's apportionment formula, Minnesota does not include in the denominators of its apportionment formula *any portion* of the property, payroll and sales factors of the foreign subsidiary, even though such factors would properly reflect the true source of the funds from which such intragroup payments are invariably made.

In short, the Minnesota "water's edge combined reporting" method takes full account of a unitary domestic subsidiary's property, payroll and sales factors for apportionment purposes, but takes no account of a unitary foreign subsidiary's factors, even though it includes the amount of interest and royalty payments made by both subsidiaries in the tax base. This has the inexorable consequence of taxing unitary foreign source income less favorably than unitary domestic source income.

B. The Proper Comparison Here

In footnote 23 in *Kraft*, this Court made clear how facial discrimination claims under the Foreign Commerce Clause are to be evaluated in a case such as this -- "it is necessary to compare the taxpayers who are 'most similarly situated.' " 505 U.S. at 80 n.23. As was true in *Kraft*, the most similarly

situated entities to compare here are a parent company with a unitary foreign subsidiary not doing business in Minnesota and a parent company with a unitary domestic subsidiary not doing business in Minnesota. Respondent agreed with that comparison in the court below.[12/]

In making its own analysis, however, the Minnesota Supreme Court completely misapplied footnote 23. First, it failed to recognize that the Tax Court's reading of footnote 23 -- which led to the comparison between a unitary foreign subsidiary and an unrelated, nonunitary domestic third party -- completely begs the question here at issue. The question to be answered is whether Minnesota impermissibly discriminates in the manner in which it taxes interest and royalties received by a parent company from its various unitary subsidiaries.

While the Minnesota Supreme Court went on to compare the tax treatment of payments made by two unitary subsidiaries, one foreign and the other domestic, it again missed the point, reasoning as follows:

> *Kraft* was a relatively easy case for the Court to decide because Iowa used a separate entity reporting method, [*Kraft*, 505 U.S. at 74 n.9], thus, the Court could directly compare Iowa's treatment of dividends received from two separate entities, *i.e.*, the domestic subsidiary and the foreign subsidiary. However, in this case, we are concerned with *combined* reporting, not single entity reporting, and thus must look at the entire apportionment formula

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12/ Respondent's Brief, Minnesota Supreme Court, 19 n.15.

> rather than simply the treatment of interest and royalties. [*Kraft*, 505 U.S. at 80-81.]
>
> Looking at the entire apportionment formula utilized under the Minnesota water's edge combined reporting method, we conclude that the Minnesota tax scheme does not facially discriminate against or unduly burden foreign commerce. Under the apportionment formula, the only foreign commerce that is subject to taxation by Minnesota are interest and royalties paid to the domestic members from the foreign subsidiaries. In contrast, the entire net income of the domestic members is subject to taxation by the Minnesota tax system. [Footnoted quotation from footnote 23 in *Kraft* and accompanying discussion omitted.]

(App. 12a-13a) (emphasis in original).

In other words, according to the Minnesota Supreme Court, combined reporting simply does not permit a comparison of the treatment of interest and royalties paid by a unitary domestic subsidiary and a unitary foreign subsidiary because all the income of the domestic subsidiary is included in the tax base.

C. The Proper Focus Here

It is certainly true that footnote 23 in *Kraft* focused on the State's tax base. But, it did so in the context of *Iowa's separate reporting system*. Indeed, that was this Court's sole focus in *Kraft*. Nothing in footnote 23 suggests that this Court gave the slightest consideration to the proper composition of either the tax base or the apportionment formula *under a "water's edge*

combined reporting" regime -- nor did it have any reason to do so. Any reliance on footnote 23 to answer the question here presented is thus completely misplaced.

Moreover, had this Court in *Kraft* intended to consider the scope of the state's apportionment formula in footnote 23 or elsewhere, it presumably would have made some reference to Justice Stevens's comments on that very subject in *Mobil*, *supra*, involving Vermont's taxation of foreign subsidiary dividends. Justice Stevens specifically addressed the proper composition of the State's apportionment formula in his dissenting opinion in *Mobil*:

> Obviously, if the foreign source income is included in the base for apportionment, foreign property, payrolls and sales must be included in the apportionment fractions. This was recognized in *Bass*[, *Ratcliff & Gretton, Ltd.* v. *State Tax Comm'n*, 266 U.S. 271] . . . .

445 U.S. at 460 n.16.

Noting that Vermont included no foreign property, payroll and sales amounts in its apportionment formula (the propriety of which was not considered by the majority on the ground that Mobil had effectively waived any objections to the State's method of apportionment), Justice Stevens further observed that "[u]nless the sales, payroll and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base *will inevitably cause Mobil's Vermont income to be overstated*." *Id.* at 460-61 (emphasis added).

Petitioner's claim of facial discrimination here directly implicates the composition of the Minnesota apportionment formula. Yet, despite its own admonition to "look at the entire apportionment formula," the court below did not properly focus on this aspect of petitioner's challenge in its analysis of footnote 23.

D. Characterization of the Royalty and Interest Payments at Issue as Either "Income" or "Expense" is Not Constitutionally Significant

To support its conclusion that the Minnesota taxing scheme does not facially discriminate against foreign commerce, the court below reasoned that including foreign subsidiary factors in the apportionment formula would be inappropriate because, in contrast to dividend payments, interest and royalties actually constitute expenses, not income, of the subsidiary making the payments.

The Minnesota court's reasoning is inconsistent with this Court's unitary business jurisprudence. In *Mobil*, this Court made it clear that the rationale for holding foreign subsidiary dividend income apportionable when the payor and payee are engaged in a unitary business is that such income represents operating income of the unitary enterprise, even though it takes the form of a dividend paid across corporate lines. Because Mobil could not "demonstrate something about the nature of the income that distinguishes it from operating income," this Court found no constitutional bar to Vermont's treating the

dividend income derived from a unitary foreign subsidiary as apportionable business income.[13/]

Mobil thus established that, for purposes of apportioning unitary business income, artificial corporate lines are essentially to be ignored. Unitary business income is considered to be the income earned by any member of the group from its dealings with third parties in the ordinary course of business operations. Intragroup payments from subsidiary to parent in the form of dividends, interest and royalties invariably have their source in the subsidiary's operating income. Irrespective of whether such payments constitute "expenses" of the subsidiary, under *Mobil* they retain their character as unitary business income when they are transferred from one member of the unitary group to another.[14/]

This Court's opinions dealing with the apportionment of unitary business income are explicit in drawing no distinction

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[13/] 445 U.S. at 440-42.

[14/] While dividend payments from a unitary subsidiary to its parent are generally seen as being tied more directly to the subsidiary's net earnings, *Mobil* makes it clear that unitary subsidiary dividends are to be viewed as representing operating income of the unitary business.

In a "separate reporting" State that includes in the parent's apportionable tax base interest and royalties received from unitary foreign and domestic subsidiaries, it is still an open question whether some portion of the subsidiaries' apportionment factors should be included in the denominators of the state's apportionment formula. Unlike the instant case, the issue there would not be one of discrimination, since both types of payments are treated alike, but one of fair apportionment. *See Mobil*, *supra* (dissenting opinion of Justice Stevens). *Cf. Conoco*, *supra*. Only a "water's edge combined reporting" method of taxation raises the issue of facial discrimination with respect to such payments.

among the various categories of intangible income derived from the unitary business relationship (*e.g.*, dividends, interest, and capital gains). In *ASARCO, Inc.* v. *Idaho State Tax Commission*, 458 U.S. 307, 330 (1982), this Court joined both the State and the taxpayer in agreeing "that interest and capital gains income derived from these [affiliated] companies should be treated in the same manner as the dividend income." And in *Allied-Signal*, *supra*, 504 U.S. at 780, this Court reiterated its position, declaring that "we have held that for constitutional purposes capital gains [from the sale of a subsidiary] should be treated as no different from dividends [citing *ASARCO*, 458 U.S. at 330]."

In characterizing the payments here involved as expenses in order to rationalize the result it reached, the court below again overlooked the real nature of petitioner's challenge. This Court's jurisprudence does not focus on how particular items of commerce are characterized, but rather on whether they are taxed in a nondiscriminatory manner.

Moreover, no matter how the payments at issue are characterized when made by a foreign subsidiary, they must be characterized in the same manner when made by a domestic subsidiary because the payments are identical. The question, therefore, is whether the differential tax treatment accorded such payments under Minnesota law is constitutionally permissible. Regardless of how the payments are labeled, Minnesota's "water's edge" method cannot facially discriminate against foreign commerce by taxing such payments less favorably when received from a foreign subsidiary doing business abroad than when received from a domestic subsidiary doing business in the United States.

II. THE COURT BELOW FASHIONED AN ENTIRELY NEW TEST FOR ESTABLISHING IMPERMISSIBLE DISCRIMINATION

In addition to revealing its misconceptions regarding the meaning and significance of this Court's prior decisions in this area, the Minnesota Supreme Court fashioned its own new test for discrimination challenges. It held that petitioner cannot complain about the tax treatment of specific items under Minnesota's "water's edge combined reporting" method *unless* petitioner also shows that this method would impose a greater overall tax burden on it than would "worldwide combined reporting," a method not adopted by Minnesota. As the court stated:

> Furthermore, on the record before us, Caterpillar has failed to meet its burden of demonstrating an undue burden on foreign commerce in this case. *See Hughes*, 441 U.S. at 336. Caterpillar has not shown the difference, if any, between the Minnesota corporate excise tax that would be paid under the water's edge combined method and the corporate excise tax that would be paid if Caterpillar's foreign members were treated similarly to its domestic counterparts.

(App. 15a).

No decision of this Court has ever required a taxpayer to prove that some other methodology, not adopted by the taxing State, might have produced a result more favorable to it before it can establish impermissible discrimination under the method adopted. This Court, in fact, has enforced a contrary rule. *See*

McLeod v. *J.E. Dilworth Co.*, 322 U.S. 327, 330 (1944) (the fact that Arkansas could have levied a tax of the same amount on the use of goods, and that such a use tax would not have exceeded constitutional limits, did not justify the sales tax that Arkansas actually chose to impose).

Minnesota, having chosen to limit its "combined reporting" method to the "water's edge," may not force taxpayers to make comparisons with other taxing methods deliberately not adopted. Once facial discrimination has been demonstrated under the method in force, this Court's opinions place no additional weight on petitioner's shoulders to prove also that an alternative method not employed by the taxing State would have produced a less burdensome result. *See Associated Indus. of Mo.* v. *Lohman*, 511 U.S. 641, 649-50 (1994) ("[A]s a general matter we have rejected reliance on any calculus that requires a quantification of discrimination as a preliminary step to determining whether the discrimination is valid . . . . [A]ctual discrimination, wherever it is found, is impermissible, and the magnitude and scope of the discrimination have no bearing on the determinative question whether discrimination has occurred."); *Maryland* v. *Louisiana*, 451 U.S. 725, 760 (1981) ("We need not know how unequal the Tax is before concluding that it unconstitutionally discriminates.").[15/]

[15/] *General Motors Corporation* v. *Tracy*, 117 S. Ct. 881 (1997), in which this Court sustained a state taxing regime that favored intrastate over interstate sales of natural gas because the two sales occurred in discrete, noncompetitive markets, has no application here. Foreign and domestic companies selling the same goods or services compete head to head, and this Court has already recognized that discrimination against the former constitutes a violation of the Foreign Commerce Clause. See *Kraft*, *supra*.

III. THE ISSUE HERE PRESENTED IS ONE OF CONSIDERABLE SIGNIFICANCE TO U.S. MULTINATIONAL CORPORATIONS THAT CARRY ON THEIR UNITARY BUSINESSES ABROAD THROUGH FOREIGN SUBSIDIARIES

Minnesota is one of 20 States that utilizes the "water's edge combined reporting" method or some variation of it, thereby taxing interest and royalty payments from foreign subsidiaries doing business abroad less favorably than such payments from domestic subsidiaries doing business in the United States.[16/] The issue here presented thus extends far beyond the boundaries of a single State and has a direct impact on foreign commerce. Discriminatory taxation of the type here involved could compel U.S. parent companies to restructure their group affairs to avoid lending money or licensing technology to unitary foreign subsidiaries, or even to cease the use of foreign subsidiaries altogether in the conduct of overseas operations, notwithstanding the many valid business reasons for their use. Such a result would be totally contrary to this Court's requirement that state taxing schemes not foreclose "tax neutral decisions" in order to survive a constitutional challenge. *Boston Stock Exch.* v. *State Tax. Comm'n*, 429 U.S. 318, 331 (1977); *Westinghouse Elec. Corp.* v. *Tully*, 466 U.S. 388, 406 (1984). *See also Kraft, supra*, 505 U.S. at 77-78.

The issue here presented is one of fundamental significance and unquestioned national importance. By misapplying settled constitutional jurisprudence and adopting a novel test of its own, the court below placed itself directly at odds with this Court's decisions in *Mobil*, *ASARCO* and *Kraft*. Other state

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16/ *See* note 5, *supra*.

courts dealing with "water's edge combined reporting" have likewise misinterpreted *Kraft* and have thereby improperly erected an impenetrable wall designed to insulate the "water's edge" regime from facial discrimination challenges of the type here involved. *Morton Thiokol*, *supra*; *Du Pont*, *supra*. This Court should therefore grant the writ in order to establish the scope of the "nondiscrimination" requirement as applied to the taxation of foreign commerce under "water's edge combined reporting."

CONCLUSION

For all of the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

JEROME B. LIBIN
(Counsel of Record)
WALTER HELLERSTEIN
TIMOTHY H. GILLIS

SUTHERLAND, ASBILL &
BRENNAN LLP
1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-0100

Counsel for Petitioner

Of Counsel:
DANIEL J. SCHLICKSUP
CATERPILLAR INC.
100 N.E. Adams Street
Peoria, Illinois 61629-4295
(309) 675-8039

DAVID R. BRENNAN
FAEGRE & BENSON LLP
2200 Norwest Center
90 South Seventh Street
Minneapolis, Minnesota 55402-3901
(612) 336-3000

December 10, 1997

Appendix

APPENDIX A

STATE OF MINNESOTA
IN SUPREME COURT
C6-97-27

Tax Court Page, J.

Caterpillar, Inc.,
Relator,

vs.

Filed: September 11, 1997

Commissioner of Revenue, Office of Appellate Courts
Respondent.

SYLLABUS

Minnesota's water's edge combined reporting method of taxing unitary business groups does not facially discriminate against foreign commerce in violation of the Foreign Commerce Clause.

Affirmed.

Heard, considered, and decided by the court en banc.

OPINION

PAGE, Justice.

Relator Caterpillar Incorporated ("Caterpillar") raises a constitutional challenge to Minnesota's corporate excise taxation system, alleging that it facially discriminates against foreign commerce in violation of the Foreign Commerce Clause of the United States Constitution. This case arose when Caterpillar sought refunds for Minnesota corporate excise taxes paid on an apportioned share of interest and royalties received from its foreign subsidiaries and a foreign affiliate that were

members of Caterpillar's unitary business[1/] during the tax years 1979-81 and 1985-87. Respondent Commissioner of Revenue ("Commissioner") denied Caterpillar's claims for the refunds. On appeal to the Minnesota Tax Court, the tax court upheld the constitutionality of the Minnesota corporate excise taxation system and affirmed the Commissioner's ruling. Caterpillar now appeals the tax court's decision and renews its constitutional challenge. We affirm.

The parties have stipulated to the facts underlying Caterpillar's appeal. Caterpillar and other domestic members of its unitary business licensed their trademarks and technology to foreign members of the unitary business in return for royalty payments. Caterpillar also provided intercompany loans to foreign and domestic members of its unitary business and received interest payments on these loans. During the years in question, three domestic members of the unitary business conducted business activity in Minnesota. which resulted in Caterpillar filing Minnesota corporate excise tax returns. During 1979-87, Caterpillar computed its Minnesota corporate excise tax liability according to Minnesota's "water's edge

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[1/] Corporations engaged in a unitary business are related through common ownership, management, and/or functional integration so that a "flow of value" and significant mutual interdependence exists between the corporations. *Container Corp. of Am. v. Franchise Tar Bd.*, 463 U.S. 159, 178-79 (1983); Minn. Stat. § 290.17, subd. 4 (1996). Members of a unitary business group may be domestic or foreign corporations and may operate in more than one jurisdiction. In this case. Caterpillar is the domestic parent corporation of the unitary business.

combined" method of reporting.[2/] *See* Minn. Stat. § 290.34, subd. 2 (1986).[3/]

Because "a State may not tax value earned outside its borders," *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982), the income of a member of a unitary business doing business in Minnesota must be divided between Minnesota and other states. Combined reporting is an accounting device that treats separate corporations engaged in a unitary business as one for the limited purpose of properly accounting for and attributing the income of any one member to a taxing state. Under combined reporting, the income of the members of a unitary business is combined and then apportioned to a particular taxing jurisdiction by using an apportionment formula that takes into account three factors--property, payroll, and sales, *see* Minn. Stat. § 290.19 (1986)--which represent the three major aspects of business activity within a taxing state. *See also* Ronald D. Rotunda & John E. Nowak, *Treatise on Constitutional Law* 192 (2d ed. 1992). Fair apportionment ensures that a "State taxes only its fair share of an interstate transaction." *Goldberg v. Sweet*, 488 U.S. 252, 260-61 (1989). It is an approximation of a corporation's income that is reasonably related to the taxing state.

[2/] Minnesota's reporting method includes a domestic, or water's edge, limitation. The term "water's edge" refers to the fact that this method of reporting does not extend beyond the water's edge, *i.e.*, the geographic boundaries of the United States, in determining what activities a state will tax. *E.I. Du Pont De Nemours & Co. v. State Tar Assessor*, 675 A.2d 82, 83 (Me. 1996).

[3/] For purposes of consistency, the parties have agreed to use the 1986 version of Minnesota Statutes in this appeal.

Minnesota's combined reporting method requires each member of a unitary business engaged in business in Minnesota to file reports disclosing the net income of the entire unitary business. For purposes of determining the net income of the unitary business and the factors to be used in the apportionment of its net income, only the income and apportionment factors of domestic members of the unitary business are included in the combined reports. *See* Minn. Stat. § 290.19, subd. 1(2)(a) (1986). The net income of these domestic members of the unitary business remains unchanged when intragroup transfers, such as interest and royalty payments, occur. *See id.* § 290.34, subd. 2 (1986) ("All intercompany transactions between [domestic] companies which are contained in the combined report shall be eliminated."). In contrast, neither the net income nor the apportionment factors--property, payroll, and sales--of a foreign member of the unitary business are included in the combined reports; rather, foreign members of the unitary business use a "separate entity" or "arm's length" method of reporting.[4/] *Id.* As a result, only interest and royalty payments made by the foreign members of the unitary business *to* the domestic members of the unitary business are included in the combined report because these payments are considered income to the domestic members. *See id.* § 290.01, subd. 20 (1986). This inclusion of the foreign members' interest and royalties payments in the combined report without taking into

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[4/] Under separate entity reporting, a corporation is treated as a separate and distinct entity that is unrelated to the unitary business, and thus dealing at "arm's length" with the unitary business. *Container Corp.* 463 U.S. at 184-85. Accordingly, the corporation is subject to taxation only by the jurisdictions in which it operates and only for the income it earns in those jurisdictions. *Id.* at 185.

consideration the foreign members' property, payroll, and sales is at the heart of Caterpillar's appeal.

In December 1993, Caterpillar filed amended Minnesota excise tax returns claiming refunds for the tax years 1979-81 and 1985-87. In these amended returns, Caterpillar included its foreign unitary business members' property, payroll, and sales in the denominator of the apportionment formula. This had the effect of decreasing the apportionment percentage and, accordingly, Caterpillar's Minnesota tax liability. On May 2, 1994, the Commissioner issued a notice of change to Caterpillar, stating that Caterpillar owed additional tax for the years 1980 and 1985, and was entitled to a refund less than the amount claimed for the years 1979, 1981, 1986, and 1987. Caterpillar filed a protest to the Commissioner's notice of change, claiming that Minnesota's taxing system unconstitutionally discriminated against interest and royalty payments made by foreign members of Caterpillar's unitary business to Caterpillar and its domestic subsidiaries in violation of the Foreign Commerce Clause of the United States Constitution. The Commissioner denied Caterpillar's protest and Caterpillar appealed to the Minnesota Tax Court. The tax court heard the parties' cross-motions for summary judgment, found that no discrimination existed, and granted the Commissioner's motion.

In reviewing findings of fact made by the tax court, this court determines whether sufficient evidence exists to support the tax court's decision. *Carlson v. Commissioner of Revenue,* 517 N.W.2d 48, 51 (Minn. 1994). However, we freely review the tax court's conclusions of law, id.; *Nagaraja v. Commissioner of Revenue,* 352 N.W.2d 373, 376 (Minn. 1984), and Caterpillar's appeal raises purely legal questions. A

taxpayer who challenges a state tax statute under the Foreign Commerce Clause carries the burden of proving that discrimination exists. *See Hughes v. Oklahoma,* 441 U.S. 322, 336 (1979); *Norton Co. v. Department of Revenue,* 340 U.S. 534, 537 (1951) ("[A] taxpayer claiming immunity from a tax has the burden of establishing his exemption."). "The power of this court to declare a statute unconstitutional is to be exercised only when absolutely necessary and with extreme caution." *Miller Brewing Co. v. State,* 284 N.W.2d 353, 356 (Minn. 1979) (citation omitted). Accordingly, we will uphold a statute unless the challenging party demonstrates that it is unconstitutional beyond a reasonable doubt. *Olson v. Ford Motor Co.,* 558 N.W.2d 491, 496 (Minn. 1997) (citation omitted).

The Commerce Clause states that "[T]he Congress shall have Power * * * To regulate U.S. Commerce with foreign Nations, and among the Several States * * * ." U.S. Const. art. I, § 8, cl. 3. Although the Commerce Clause expressly gives Congress the power to regulate commerce with foreign nations and among the states, the Clause also contains an implied negative command, known as the "dormant" Commerce Clause, which prohibits states from discriminating against foreign trade even where Congress has failed to legislate on the subject. *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.,* _ *U.S.* _, 115 S. Ct. 1331, 1335 (1995); *see also* Laurence H. Tribe, *American Constitutional Law* 469 (2d ed. 1988) ("Limits on state authority to tax foreign commerce are implicit in the commerce clause's grant of congressional power to regulate foreign commerce."). In *Complete Auto Transit v. Brady,* 430 U.S. 274 (1977), the United States Supreme Court adopted a four-part test to determine whether a state's tax system violates

the Commerce Clause. To pass constitutional muster, a state tax must: "[1] [be] applied to an activity with a substantial nexus with the taxing State, [2] * * * [be] fairly apportioned, [3] * * * not discriminate against interstate commerce, and [4] * * * [be] fairly related to the services provided by the State." *Id.* at 279. If the state tax fails any part of this test, then the tax is unconstitutional under the Commerce Clause. *Id.*

When foreign commerce is involved, additional scrutiny is required. In *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), the Supreme Court directed that, when dealing with foreign commerce, in addition to the four-part *Complete Auto* test, the court must inquire as to whether the tax, notwithstanding apportionment, created an "enhanced risk of [international] multiple taxation," *id.* at 446, and must also ask whether the tax prevents the federal government from "speaking with one voice" when regulating commercial relations with foreign governments, *id.* at 451; that is, the tax must not "impair federal uniformity in an area where federal uniformity is essential." *Id.* at 448. If a state tax contravenes either of the two *Japan Line* factors, or any of the *Complete Auto* factors, the tax violates the Commerce Clause. *Id.*

Caterpillar bases its challenge to Minnesota's water's edge combined reporting method solely on the "discrimination" prong of the *Complete Auro* test. In its brief to this court, Caterpillar identifies the issue in this appeal as follows:

> [I]ntragroup interest and royalties paid by a foreign member of the group not doing business in Minnesota are treated less favorably than intragroup interest and royalties paid by a domestic member of the group not doing business in the state.

Caterpillar's position is that under the principles articulated by the U.S. Supreme Court in *Kraft v. Iowa*,[5] this less favorable taxation of foreign source intragroup interest and royalty payments constitutes facial discrimination under the Foreign Commerce Clause.[6]

As an initial matter, we are not wholly convinced that Caterpillar proposes the correct basis for comparison. Caterpillar argues that the Constitution prohibits Minnesota's

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[5] The case of *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin.* involved a unitary business with both domestic and foreign subsidiaries whose dividends were subject to taxation by the state of Iowa. 505 U.S. 71, 72 (1992). The United States Supreme Court held that Iowa's tax scheme, which utilized a single entity reporting method, facially discriminated against foreign commerce in violation of the Foreign Commerce Clause. *Id.* at 82.

[6] Caterpillar attempts to support its position by characterizing interest and royalty payments made by the foreign members of the unitary business to domestic members of the unitary business as payments of the foreign members' earned *income* and by characterizing Minnesota's taxation of these payments as placing a tax burden on the foreign members' income. Thus, Caterpillar argues, if foreign-member income is included in the apportionment formula, then foreign-member property, payroll, and sales must also be included; otherwise, facially discriminatory treatment results. However, Caterpillar's characterization of foreign-member interest and royalty payments as income is a mischaracterization; interest and royalty payments are *expenses* to the foreign member which are presumably deducted from net sales before earned income can be determined. *Cf.* Minn. Stat. §§ 290.01, subd. 22; 290.21, subd. 8 (1986). In reality, interest and royalty payments made by a foreign member of a unitary business to a domestic member in that same unitary business constitute *income to the payee-domestic member*, not income of the payor-foreign member. Moreover, interest and royalty payments are typically the result of contractual obligations and are payable whether the subsidiary realizes net income or sustains a loss.

form of corporate excise tax because it taxes interest and royalties from foreign subsidiaries of a unitary business, but does not tax such receipts from domestic subsidiaries of the unitary business. It may be, however. that the constitutionally relevant comparison is not between receipts from foreign and domestic *subsidiaries,* but between foreign subsidiaries and *unrelated* domestic entities. For purposes of calculating the tax at issue, the Minnesota legislature has essentially chosen to treat Caterpillar's foreign subsidiaries as unrelated entities and their interest and royalty payments as arm's length transactions. Assuming that the state has a legitimate reason for doing so--for example, to avoid problems multinational corporations face with the worldwide combination reporting method[7]--Minnesota's corporate excise tax would surely not "discriminate" against interest and royalty payments from

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[7] The "worldwide combination" reporting method includes both domestic and foreign-member income and apportionment factors in the apportionment formula and the United States Supreme Court has upheld this method against Due Process and Commerce Clause challenges. *See Container Corp.*, 463 U.S. at 162-63, 184; *Barclays Bank PLC v. Franchise Tax Bd.*, _ *U.S.* _, 114 S. Ct. 2268, 2273 (1992). However, states have moved away from using this method of reporting because of, among other things, distortion in the apportionment factors resulting from differences in profit margins, capital investment costs, wage rates, and accounting methods among various foreign countries, and the potential problem of international double taxation of the foreign subsidiary's net income. *See* Jerome R. Hellerstein & Walter Hellerstein, *State and Local Taxation* 538-39 (4th ed. 1978); Ruurd G. Leegstra et al., *The California Water's Edge Election,* 6 Journal of State Tax'n 195 195 (1987). In fact, by 1992, no states used worldwide combination reporting without a water's edge limitation. I Jerome R. Hellerstein & Walter Hellerstein, *State Taxation. Corporate Income & Franchise Taxes* ~ 8.16 (2d ed. 1993) [hereinafter "I Hellerstein & Hellerstein"].

foreign entities: such receipts are treated exactly the same when provided by unrelated domestic entities.

But even assuming that Caterpillar's chosen basis for comparison is correct, we are unpersuaded that Caterpillar has demonstrated any constitutionally cognizable "discrimination" under the Foreign Commerce Clause. In light of existing precedent. the operation and purpose of Minnesota's tax statute, and the understanding that the burden of persuasion rests with Caterpillar, we conclude that the Minnesota corporate excise tax statute does not facially discriminate against foreign commerce.

The United States Supreme Court has developed various formulations for what constitutes state tax discrimination. A tax may violate the Commerce Clause if it is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening foreign commerce. *See Amerada Hess Corp. v. Director, Div. of Taxation, New Jersey Dep't of the Treasury,* 490 U.S. 66, 75 (1989). When deciding cases involving challenges based on facial discrimination, the Supreme Court still examines the burdens on interstate commerce rather than simply determining whether intrastate, interstate, and foreign commerce receive identical treatment under a state's tax law. *See Fulton Corp. v. Faulkner, U.S.* , 116 S. Ct. 848, 854 (1996) (finding a tax discriminatory if it "tax[es] a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the state") (citation and internal quotation marks omitted); *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin.,* 505 U.S. 71, 79-80 (1992) (finding that Iowa's facially discriminatory tax "imposes a burden on foreign subsidiaries that it did not impose

on domestic subsidiaries").[8] "State tax discrimination is, then, in part, inequality resulting from a state imposing greater state tax burdens on certain taxpayers than on others." Philip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause,* 39 Vand. L. Rev. 879, 898 (1986). Thus, the antidiscrimination prong of the *Complete Auto* test is best viewed as promoting equal treatment of domestic and foreign commerce, but not identical treatment of all taxpayers engaged in domestic and foreign commerce. *Id.* at 925.

Specifically, Caterpillar argues that the water's edge combined reporting method, used by Minnesota to calculate corporate excise taxes, facially discriminates against foreign commerce because it taxes the interest and royalties paid by foreign members of a unitary business to domestic members of the unitary business without including the foreign members'

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[8] The Commissioner argues that, because Caterpillar contends that the Minnesota tax scheme *is facially* discriminatory, Caterpillar must show that the tax plan will always lead to an unconstitutional result pursuant to *United States v. Salerno,* 481 U.S. 739 (1987). In *Salerno,* the United States Supreme Court held that the Bail Reform Act of 1984 was not facially invalid, and in doing so, stated, "[a] facial challenge to a legislative Act is, of course, the most difficult challenge to mount successfully, since the challenger must establish that no set of circumstances exists under which the Act would be valid." *Id.* at 745.

Although *Salerno* has not been expressly overruled, the Supreme Court failed to apply this test in *Kraft. See* 505 U.S. at 82-83 (Rehnquist, J., dissenting) (arguing that *Salerno's* "no set of circumstances test" should have been applied). This suggests that the *Salerno* principle does not accurately characterize the standard for deciding facial challenges to state tax statutes. *See* Michael C. Dorf, *Facial Challenges to State and Federal Statutes,* 46 Stan. L. Rev. 235, 236 (1994).

property, payroll, and sales in the apportionment formula, while at the same time including property, payroll and sales in the apportionment formula for domestic members who pay interest and royalties to domestic members of the unitary business.

In support of its argument, Caterpillar relies on the United States Supreme Court's decision in *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin.*, 505 U.S. 71 (1992). In *Kraft*, the Supreme Court held that Iowa s corporate income tax unconstitutionally discriminated against foreign commerce because it included dividends from foreign subsidiaries, but not from domestic subsidiaries, in the taxpayer's tax base.[9] *Id.* at 77, 82. The Supreme Court reached this conclusion despite Iowa's attempt to conform its tax system to the federal corporate income tax system. *Id.* at 82.[10] *Kraft* was a

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[9] Kraft was a domestic corporation in a unitary business with a number of domestic and foreign subsidiaries. *Kraft*, 505 U.S. at 72. Because Kraft conducted part of its business in Iowa, it was required to file a corporate tax return in that state. *Id.*

[10] Under the federal corporate income tax, there is a deduction for dividends received from domestic subsidiaries but not for dividends received from foreign subsidiaries. *See id.* at 73; I.R.C. § 243. The purpose of the former deduction is to avoid a second tax on the earnings of domestic corporations, all of which are subject to federal taxation. *Kraft*, 505 U.S. at 73. To avoid double taxation of the earnings of foreign corporations, which are not generally subject to federal taxation, federal tax law provides for a credit against foreign taxes paid on such earnings that are also subject to federal taxation, including taxes paid on earnings that are repatriated in the form of dividends. *Id.*; I.R.C. §§ 901, 902.

Like the federal scheme, Iowa's tax law did not allow a parent corporation to deduct dividends received from foreign subsidiaries; (continued...)

relatively easy case for the Court to decide because Iowa used a separate entity reporting method, *see id.* at 74 n.9, thus, the Court could directly compare Iowa's treatment of dividends received from two separate entities, i.*e.*, the domestic subsidiary and the foreign subsidiary. However, in this case, we are concerned with *combined* reporting, not single entity reporting, and thus must look at the entire apportionment formula rather than simply the treatment of interest and royalties. *See id.* at 80-81 (stating that, in evaluating alleged facial discrimination from a state tax, "it is not proper to ignore the operation of other provisions of the *same* statute.") (quoting *amicus* brief of the United States) (emphasis in original).

Looking at the entire apportionment formula utilized under the Minnesota water's edge combined reporting method, we conclude that the Minnesota tax scheme does not facially discriminate against or unduly burden foreign commerce. Under the apportionment formula, the only foreign commerce that is subject to taxation by Minnesota are interest and royalties paid to the domestic members from the foreign subsidiaries. In contrast, the entire net income of the domestic members is subject to taxation by the Minnesota tax system.[11/]

[10/] (...continued)
however, unlike the federal scheme, Iowa's tax law also did not allow the corresponding credit for taxes paid to foreign countries. *Kraft,* 505 U.S. at 74. Thus, lowa's tax law treated dividends received from foreign subsidiaries less favorably than dividends received from domestic subsidiaries in a unitary business.

[11/] The Supreme Court observed in a footnote in *Kraft* that:

> If one were to compare the aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business

(continued...)

Indeed, the underlying purpose of Minnesota's water's edge combined reporting method of taxations to avoid taxing the foreign subsidiaries' income in the United States by treating them as separate entities engaging in arm's length transactions with the rest of the unitary group. Thus, in light of the operation and purpose of the Minnesota statute, we cannot say that it facially discriminates against or unduly burdens foreign

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11/ (...continued)
throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent.

505 U.S. at 80 n.23. We find this footnote instructive by analogy to interest and royalties. We also acknowledge that two other state supreme court decisions, both of which involved constitutional challenges to a water's edge combined method of reporting and the treatment of dividends, distinguished the *Kraft* decision in upholding their states' taxation schemes. *See Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175, 1186 (Kan. 1993) (holding that Kansas' domestic combination reporting method was not more burdensome on foreign commerce because income of the domestic subsidiaries was combined, apportioned, and taxed, while only the dividends from the foreign subsidiaries were taxed); E.I. *Du Pont*, 675 A.2d at 88 (holding that Maine's water's edge combined reporting method provided a "taxing symmetry" for domestic and foreign commerce and that "the inclusion of dividends paid by foreign subsidiaries [did] not constitute the kind of facial discrimination against foreign commerce that caused the Supreme Court to invalidate Iowa's tax scheme in *Kraft.*"); *see also Conoco, Inc. v. Taxation & Revenue Dep't*, 931 P.2d 730, 735 (N.M. 1996) (distinguishing domestic combination reporting and striking down New Mexico's separate entity reporting method that was similar to the Iowa reporting method struck down in Kraft).

commerce. Furthermore, on the record before us, Caterpillar has failed to meet its burden of demonstrating an undue burden on foreign commerce in this case. *See Hughes, 441 U.S.* at 336. Caterpillar has not shown the difference, if any, between the Minnesota corporate excise tax that would be paid under the water's edge combined method and the corporate excise tax that would be paid if Caterpillar's foreign members were treated similarly to its domestic counterparts.

Finally, we observe that the creation of water's edge reporting was an effort to avoid double taxation on multinational corporations, *i.e.*, taxation by both the United States and a foreign country, as well as the problems associated with the worldwide combination reporting method. In fact, the impetus for states to utilize water's edge reporting instead of worldwide combination reporting originated from multinational companies, such as Caterpillar. *See* I Hellerstein & Hellerstein ¶ 8.16.[12/] This effort to avoid international multiple taxation does not appear to implicate the judicial policy against "discrimination" of foreign commerce; rather, a decision threatening such legislative efforts would appear to work against the very purposes of the dormant Foreign Commerce Clause doctrine.

Affirmed.

[12/] "[T]he States yielded to economic and political pressures and threats of multinationals * * * that they would not locate new plants in States that apply the unitary method to the apportionment of their incomes, and the political threat of Federal legislation that would restrict the use of worldwide apportionment by the States." I Hellerstein & Hellerstein ¶ 8.16.

APPENDIX B

STATE OF MINNESOTA — TAX COURT
COUNTY OF RAMSEY — REGULAR DIVISION

Catepillar, Inc.

Appellant, ORDER GRANTING MOTION FOR SUMMARY JUDGMENT

vs.

Commissioner of Revenue, Docket No. 6633

Appellee.

Dated: November 14, 1996

This matter was submitted on stipulated facts and was heard by the Honorable Kathleen Doar, Chief Judge of the Minnesota Tax Court, on August 19, 1996, at the Minnesota Judicial Center, 25 Constitution Avenue, St. Paul, Minnesota.

Jerome B. Libin, Attorney at Law, represented the Appellant.

Thomas K. Overton, Assistant Attorney General, appeared for the Appellee.

The Court, having heard and considered the arguments of counsel, and upon all of the files, records and proceedings herein, now makes the following:

ORDER

1. The Appellant's motion for Summary Judgment is denied.

2. The Appellee's motion for Summary Judgment is granted.

3. The Commissioner of Revenue's Order dated March 24, 1995 is hereby affirmed.

IT IS SO ORDERED. BY THE COURT,

Kathleen Doar, Chief Judge
MINNESOTA TAX COURT

DATED: November 14, 1996

MEMORANDUM

Caterpillar, Inc. ("caterpillar") manufactures and sells engines and earth-moving equipment in the United States and abroad. During the years 1979 to 1987, the years at issue in this appeal, Caterpillar was domiciled in Illinois. Caterpillar was a California corporation from 1979 to 1985 and was reorganized as a Delaware corporation in 1986.

Caterpillar is the parent of subsidiaries incorporated in the United States and various foreign jurisdictions ("Domestic Subsidiaries" and "Foreign Subsidiaries," respectively). The parties agree that Caterpillar and its Domestic Subsidiaries and Foreign Subsidiaries engage in a unitary business.[1/] Caterpillar and two of its Domestic Subsidiaries, Solar Turbines Incorporated and Caterpillar Financial Services Corporation, conduct business in Minnesota (the "Minnesota Members").

[1/] The Commissioner of Revenue does not concede that all of Caterpillar's Foreign Subsidiaries were part of the unitary group during the years at issue. However he does agree, for purposes of this motion, that at least one of the Foreign Subsidiaries was part of the unitary group.

Each Minnesota Member required to pay a Minnesota excise tax measured by taxable net income. Minn. Stat. § 290.02.

None of the Minnesota Members does business exclusively in Minnesota. Because a state may not constitutionally tax income earned outside its borders, the income earned by each Minnesota Member must be apportioned between Minnesota and other jurisdictions. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983). During the years at issue the excise tax for each Minnesota Member was calculated using the combined method of reporting which allocates to Minnesota a portion of the combined net income of the unitary business from entities incorporated in the United States (the "Minnesota Waters-Edge Combined Method").[2/3/]

In general terms, the Minnesota Waters-Edge Combined Method multiplies the combined net income of domestic unitary corporations by an apportionment percentage calculated using a three factor formula. The factors include property, Davroll and sales. The total for each factor for the corporation subject to Minnesota tax is compared to the total for each factor

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[2/] Minn. Stat. § 290.34, subd. 2 (1986), which the parties agree applies to the years at issue, read in relevant part as follows: The combined report shall reflect income only from corporations created or organized in the United States or under the laws of the United States or of any state, the District of Columbia, the commonwealth of Puerto Rico, any possession of the United States, or any political subdivision of any of the foregoing and from a FSC as defined in section 922 of the Internal Revenue Code . . . .

[3/] Minnesota did not require or permit combined reporting during the years 1979-1981. However a corporation with a net operating loss in 1982-1984 could carry its loss back "as if" it had filed on a combined basis. Because Caterpillar did so, the tax for all years at issue was calculated using the Minnesota Waters-Edge Combined Method.

for all domestic corporations in the unitary group and is expressed as a fraction, i.e. the numerator of each factor is the amount of the Minnesota property, payroll or sales and the denominator of each factor is the amount of all the domestic unitary group's property, payroll or sales. The percentages determined by dividing each numerator by its denominator are averaged and the combined net income of the domestic unitary group is multiplied by the average percentage figure to determine the amount of income allocated to Minnesota. Allocable income is multiplied by the tax rate to determine tax.

During the years at issue Caterpillar and some of its Domestic Subsidiaries licensed trademarks and technology to Foreign Subsidiaries and unrelated third parties in exchange for royalties. Caterpillar also loaned funds to both Domestic Subsidiaries and Foreign Subsidiaries in exchange for interest. Royalty and interest transactions were reported as arms-length transactions on federal consolidated income tax returns and nothing in the record suggests they were not arms-length.

When calculating the Minnesota excise tax under the Minnesota Waters-Edge Combined Method, the Commissioner of Revenue (the "Commissioner") included interest payments and royalties received from Foreign Subsidiaries and interest received from Domestic Subsidiaries in combined net income.[4/]

[4/] Interest and royalties received by Caterpillar from Foreign Subsidiaries were included as income to Caterpillar. Intercompany transactions (i.e. interest and royalty payments) within the Minnesota Waters-Edge Combined Method unitary group were eliminated. Min. Stat. § 290.34, subd. 2 (1986). Therefore interest received from Domestic Subsidiaries was included in the Domestic Subsidiaries net income which was combined with the income of the entity subject to Minnesota tax.

He included the property, payroll and sales factors of all Domestic Subsidiaries in the apportionment fraction denominators but excluded Foreign Subsidiary factors from the apportionment fraction denominators.[5/]

ARGUMENT

The United States Constitution grants Congress the power "[T]o regulate commerce with foreign Nations and among the several States." U.S. Const. art. I, § 8, cl. 3 (the "Commerce Clause"). Although it speaks of a Congressional grant of power, the Commerce Clause also limits a state's power to erect barriers against interstate and foreign trade. Barclays Bank PLC v. Franchise Tax Board of California, U.S. , 114 S. Ct. 2268 (1994). A state may tax interstate and foreign commerce if the tax: (1) is applied to an activity with a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against foreign commerce; and (4) is fairly related to the services provided by the state. See Complete Auto Transit Inc. v. Brady, 430 U.S. 274 (1977); Japan Line LTD. v. County of Los Angeles, 441 U.S. 434 (1979); Barclays Bank.

The sole issue is discrimination. Caterpillar argues that the Minnesota Waters-Edge Combined Method facially discriminates against foreign commerce. In particular, it argues that the inclusion of interest and royalties from Foreign Subsidiaries in the combined net income base without the inclusion of Foreign Subsidiaries' property, payroll and sales

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[5/] The history of the excise tax calculations at issue (claims for refunds and protests) is irrelevant for purposes of this motion. Caterpillar appeals from a March 24, 1995 Order of the Commissioner which calculated excise tax as described above.

factors in the apportionment fraction denominators violates the third prong of the Complete Auto test.

Caterpillar relies entirely upon principles articulated by the United States Supreme Court in Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance, 505 U.S. 71 (1992). In Kraft the Supreme Court held that the fact that dividends received from a unitary business' foreign subsidiaries were treated less favorably than dividends received from its domestic subsidiaries constituted unconstitutional discrimination under the Commerce Clause.[6/] Iowa did not include dividends paid by domestic subsidiaries in its excise tax base (they were deductible) but did include dividends paid by foreign subsidiaries in the tax base. Such a pattern facially discriminated against foreign-source income.

Caterpillar acknowledges that income and royalties received from both Foreign and Domestic Subsidiaries are included in the tax base under the Minnesota Waters-Edge Combined Method but argues that because the Foreign Subsidiaries' factors are not included in the apportionment fraction denominators, a larger portion of the foreign payments are included in Minnesota allocable income. Such a scenario, it argues, also facially discriminates against foreign source income.

HOLDING

In Kraft the Supreme Court noted: "t[]n considering claims of discriminatory taxation under the Commerce Clause . . . . it is necessary to compare the taxpayers who are "most similarly

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[6/] Neither the foreign nor the domestic subsidiaries did business in Iowa.

situated". Kraft, 505 U.S. at 80 n.23. The Supreme Court of Kansas has stated: "We interpret the significance of footnote 23 . . . to be in identifying the appropriate comparison." In re Mormon Thiokol. Inc., 864 P.2d 1175, 1186 (Kan. 1993). The crux of this case lies in identifying "similarly situated" entities for purposes of this Commerce Clause discrimination claim.

The Kraft domestic and foreign dividend-paying entities were similarly situated as subsidiaries in the Kraft unitary business and were similarly situated under Iowa's business tax law. Because Iowa was a separate reporting state, none of the income of either the domestic or foreign subsidiaries compared in Kraft was included in the Iowa business tax base.[7/] The Supreme Court distinguished the above situation from a comparison between a domestic subsidiary doing business throughout the United States including Iowa and a foreign subsidiary. In that circumstance the Court indicated, the entities would not be similarly situated because the domestic subsidiary doing business in Iowa would itself be subject to Iowa business tax.[8/] Kraft, 505 U.S. at 80 n.23.

In the instant case, royalty and interest-paying Foreign Subsidiaries are similarly situated to Domestic Subsidiaries as members of the Caterpillar unitary business but they are not similarly situated to Domestic Subsidiaries under Minnesota Waters-Edge Combined Method because the unitary group for

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[7/] The foreign dividend was taxed as income received by the entity doing business in Iowa and subject to Iowa business tax. The domestic dividend was income to the entity doing business in Iowa but was deductible.

[8/] Under Iowa's separate reporting method an apportioned share of the entire income of the subsidiary doing business in Iowa would be subject to tax.

excise tax purposes excludes corporations organized in foreign jurisdictions. The question is: which similar situation controls?

We find the appropriate comparison is between entities which are similarly situated within the meaning of the Minnesota Waters-Edge Combined Method, i.e. between entities which are not part of the unitary group for excise tax purposes. We reach this conclusion noting that the Supreme Court in Kraft differentiated the "situations" of two domestic subsidiaries by reference to their position under Iowa's tax law, not by reference to their relationship to the unitary business.

We therefore compare the way Minnesota's Water-Edge Combined Method treats royalties received from non-related domestic third parties to the way it treats royalties received from the Foreign Subsidiaries. In each case, royalties are included in the combined net income tax base and the factors of the royalty payor are excluded from the apportionment formula fraction denominators. Because royalties and interest received by a Minnesota Member from Foreign Subsidiaries and domestic entities are treated the same way, we find no discrimination against foreign-source income and no violation of the Commerce Clause. We therefore deny Caterpillars motion and affirm the Commissioner's Order.

K.D.

APPENDIX C

STATE OF MINNESOTA
TAX COURT

CATERPILLAR INC.,	)	In the matter of the
	)	Appeal from the
Appellant,	)	Commissioner's Notice
	)	of Determination on
-v-	)	Appeal dated March
	)	24, 1995 relating to
THE COMMISSIONER OF	)	Caterpillar Inc. tax
REVENUE OF THE	)	for the Calendar Years
STATE OF MINNESOTA	)	1979, 1980, 1981,
	)	1982, 1983, 1984,
Appellee.	)	1985, 1986 and 1987.
	)	
	)	Docket No. 6633

STIPULATION OF FACTS

It is hereby stipulated that for purposes of this case the following statements are accepted as fact and all exhibits referred to herein are incorporated in this Stipulation and made a part hereof; provided, however, that the parties may introduce other and further evidence not inconsistent with the facts herein stipulated, and provided further, that either party may object to any of the facts or documents herein on the grounds of materiality or relevancy. All other evidentiary objections are waived unless specifically expressed in this Stipulation. Unless

the context requires otherwise, all factual statements refer to events and conditions during the 1979-1987 tax years ("tax years").

A. **The Caterpillar Group**

1. During the years 1979-1987, Caterpillar Inc.[1/] owned numerous domestic (U.S.) and foreign subsidiaries, and one foreign affiliate.[2/] Caterpillar Inc. and these companies shall be referred to collectively as the "Caterpillar Group." The term "Caterpillar Unitary Group" includes Caterpillar Inc. and those members of the Caterpillar Group that were engaged in a unitary business in any or all of 1979-1987.

2. The domestic members of the Caterpillar Group in 1979-1987 are provided in Joint Exhibit A-1.[3/] Appellee concedes that each of the domestic members of the Caterpillar Group was part of the Caterpillar Unitary Group during any or all of 1979-1987.

[1/] Prior to 1987, Caterpillar Inc. was known as Caterpillar Tractor Co. The company is hereinafter referred to as Caterpillar Inc.

[2/] Caterpillar Inc. had interests in other foreign corporations but such interests were de minimis.

[3/] "Domestic" means a corporation incorporated in the U.S. or a foreign sales corporation as defined under Internal Revenue Code § 922. "Foreign" means a non-domestic corporation. Appellant does not concede the propriety of Minnesota's inclusion of Caterpillar Export Ltd., a foreign sales corporation, as a domestic member of the Caterpillar Group. However, appellant does not challenge such determination in this litigation

3. The foreign members of the Caterpillar Group in 1979-1987 are provided in Joint Exhibit B-2.[4] Appellee does not concede that each of the foreign members of the Caterpillar Group was part of the Caterpillar Unitary Group. However, for purposes of appellant's motion for summary judgment, appellee concedes that one or more of the foreign members of the Caterpillar Group were part of the Caterpillar Unitary Group and that such companies made interest and/or royalty payments to Caterpillar Inc. during any or all of 1979-1987. Appellee's concession is intended to enable this Court to rule upon appellant's motion for summary judgment. The parties agree that if this Court determines that the Minnesota combined reporting system, as a matter of law, discriminates against foreign commerce in violation of the Foreign Commerce Clause of the U.S. Constitution, appellee may seek to determine thereafter which foreign members of the Caterpillar Group were members of the Caterpillar Unitary Group during the tax years.

B. <u>Members of the Caterpillar Unitary Group Operating in Minnesota</u>

4. Caterpillar Inc., Solar Turbines Incorporated ("Solar") and Caterpillar Financial Services Corporation ("CFSC") are corporations duly organized and existing under the laws of the State of Delaware.

5. The principal offices of Caterpillar Inc. and CFSC during the tax years were at Peoria, Illinois. The principal office of Solar during the tax years was at San Diego, California.

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[4] See footnote 3.

6. CFSC and Solar are wholly-owned subsidiaries of Caterpillar Inc.

7. Caterpillar Inc., Solar, and CFSC each conducted business within and without Minnesota during the tax years. Their business activity in Minnesota included the ownership of property located within Minnesota, the presence of personnel in Minnesota, and the sale and financing of product to independent dealers in Minnesota. Neither Caterpillar Inc., Solar, nor CFSC had any manufacturing operations in Minnesota during the tax years. The respective property, payroll and sales of Caterpillar Inc., Solar, and CFSC within Minnesota for 1979-1987 are provided in Joint Exhibit C-3. Caterpillar Inc., Solar, and CFSC and hereinafter referred to as the "Minnesota Members of the Caterpillar Group."

C. **Net Income or Loss Before Tax**

8. The net income (or loss) before taxes of the domestic members of the Caterpillar Group in 1979-1987 is provided in Joint Exhibit D-4.[5/]

9. The net income (or loss) before taxes of the foreign members of the Caterpillar Group in 1979-1987 is provided in Joint Exhibit E-5.[6/]

[5/] Interest and royalties paid were deducted in calculating net income (or loss).

[6/] Id.

D. Transactions Between Members of the Caterpillar Group

10. Caterpillar Inc. and certain other domestic members licensed their trademarks and technology to certain foreign members of the Caterpillar Group (one or more of such foreign members being part of the Caterpillar Unitary Group) in return for royalty payments. A sample license agreement is provided in Joint Exhibit L-12. Caterpillar Inc. and certain other domestic members licensed their trademarks and technology to certain other domestic members of the Caterpillar Group, but did not pay or receive royalties pursuant to cross-licensing arrangements. Caterpillar Inc. and certain other domestic members entered into various licensing agreements with unrelated third parties. Royalties were required and paid for some licenses and not for others. Caterpillar Inc. also provided intercompany loans to certain foreign and domestic members of the Caterpillar Group (one or more of such foreign members being part of the Caterpillar Unitary Group), and received interest payments thereon.

11. The 1979-1987 interest payments paid to Caterpillar Inc. by domestic members of the Caterpillar Group are provided in Joint Exhibit F-6.

12. The 1979-1987 royalty and interest payments paid to Caterpillar Inc. by foreign members of the Caterpillar Group are provided in Joint Exhibit G-7. One or more of these royalty and interest payments were made by one or more foreign members of the Caterpillar Unitary Group.

E. Calculation of Federal Income Tax Liability

13. In the consolidated federal income tax return filed by Caterpillar Inc. for the tax years (such return included Caterpillar Inc., its 80%-or-more-owned domestic subsidiaries, and two foreign subsidiaries pursuant to election made under I.R.C. §1504 (d) and §953 (d) (Caterpillar Mexicana S.A. de C.V. and Conek S.A. de C.V., respectively)), the royalty and interest payments received from non-consolidated foreign members of the Caterpillar Group were treated as foreign source income of the domestic recipient corporation. Transactions between members of the federal consolidated group and non-consolidated foreign members of the Caterpillar Group were required to be reported on an arms-length basis as required by Internal Revenue Code § 482 and regulations thereunder. These amounts were included in the figure shown on Line 28 on the federal consolidated income tax return (federal taxable income before net operating losses and special deductions).[2/]

14. Taxes were paid to foreign governments by Caterpillar Inc. and some domestic members of the Caterpillar Group in 1979-1987 with respect to royalties and interest received from certain foreign members of the Caterpillar Group. The foreign governments of the countries in which the foreign members of the Caterpillar Group were located required the foreign payor members to withhold tax on the interest and royalty payments

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[2/] Payments of royalties and interest by domestic members of the Caterpillar Group are deductible in computing line 28. Payments of royalties and interest by foreign members of the Caterpillar Group were deducted on the foreign income tax returns of the foreign member making the payment.

they made. Although the foreign payor member was responsible for withholding and remitting the tax to the foreign government, the domestic recipient of the royalty or interest payments was liable under foreign law for the tax. Federal law allows a foreign tax credit for foreign taxes paid by domestic corporations. Minnesota law did not allow a tax credit or deduction for United States or foreign income taxes paid.

F. Calculation of Minnesota Income Tax Liability

15. In each of the 1982-1987 tax years, Minnesota law required each Minnesota Member of the Caterpillar Group to compute its Minnesota corporate franchise tax on a combined return, which combined the net income and apportionment factors of the domestic members of the Caterpillar Unitary Group, but excluded the net income and appo~cionment factors of the foreign members of the Caterpillar Group. The Minnesota tax liability was calculated pursuant to the following seven-step process:[8/]

[8/] For the years 1979-1981, Minnesota did not require or permit combined reporting. Instead, Minnesota required each corporation subject to Minnesota tax to file a separate entity return. There was, however, an exception if a corporation elected to carry a net operating loss from a combined reporting year back to a separate entity reporting year. A corporation with a net operating loss in 1982-1984 could carry its loss back three years to a separate return year only if: (1) it recomputed the carryback year "as if" it had filed on a combined basis, and (2) it paid any additional tax due as a result of the "as if" recomputation. In the alternative, the corporation could elect to carry the loss forward for the usual five years, plus however many of the three preceding years were separate return years. Because Caterpillar carried net operating losses back from combined reporting years to the years 1979-1982, Caterpillar recomputed its tax for 1979-1982 "as if" it filed on a combined basis for those years and the seven

(continued...)

Step 1. The federal taxable incomes (subject to certain adjustments not at issue here) of each of the domestic members of the Caterpillar Group (the "Minnesota Combined Group") were combined to produce a single combined income ("Combined Income"). The net income of foreign members of the Caterpillar Group was not included in Combined Income. All transactions between members of the Minnesota Combined Group were eliminated in computing Combined Income (i.e., those transactions were treated as if they had not been made). Thus, interest income received by Caterpillar Inc. from members of the Minnesota Combined Group was eliminated and the corresponding interest expense paid by members of the Minnesota Combined Group was also eliminated.

Step 2. The property, payroll and sales amounts within Minnesota for each of the Minnesota Members of the Caterpillar Group were the numerators of the property, payroll and sales factors for that company.

Step 3. The property, payroll and sales amounts everywhere of all of the members of the Minnesota Combined Group were combined to determine the denominators of the property, payroll and sales factors for the entire Minnesota Combined Group.

Step 4. The numerators of the factors determined in Step 2 were divided by the denominators of the factors determined in Step 3 to calculate the property, payroll and sales percentages of each of the Minnesota Members of the Minnesota Combined Group.

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[9] (...continued)
steps described were followed.

Step 5. For each Minnesota member of the Minnesota Combined Group, the three percentages determined in step 4 for that Minnesota Member were added and divided by three to obtain the arithmetic average apportionment percentage for that member.

For each Minnesota member, the property percentage determined in Step 4 was multiplied by .15, its payroll percentage determined in Step 4 was multiplied by .15, and its sales percentage determined in Step 4 was multiplied by .7. The resulting three numbers were then added to determine the Minnesota weighted apportionment percentage for that Minnesota Member of the Minnesota Combined Group. The apportionment percentage used for each Minnesota Member was either its arithmetic average apportionment percentage or its weighted apportionment percentage, whichever was lower.

Step 6. For each Minnesota Member, the Minnesota apportionment percentage for that member (determined in Step 5) was multiplied by the combined income (determined in Step 1) to determine the Minnesota taxable net income of that member.

Step 7. The Minnesota taxable net income of each Minnesota Member (determined in Step 6) was then multiplied by the Minnesota tax rate to compute the Minnesota tax liability for that member.

G. Administrative Record

16. In December 1993, following a federal tax audit, Caterpillar Inc. filed amended Franchise Tax returns claiming refunds for all of the tax years except the years ending December 31, 1982, December 31, 1983, and December 31,

1984. On May 2, 1994, after considering the amended returns, the Department issued a Notice of Change in Your Tax ("Notice of Change"), stating that Caterpillar Inc. owed additional tax for the years ending December 31, 1980 and December 31, 1985. The Department also stated that Caterpillar Inc. was entitled to refunds in respect of the years ending December 31, 1979, December 31, 1981, December 31, 1986 and December 31, 1987. The Department held that Caterpillar Inc. was entitled to a net refund which was less than the amount claimed by Caterpillar Inc. By letter dated June 27, 1994, Caterpillar Inc. filed a protest (the "Protest") concerning the adjustments proposed in the Notice of Change. In the Protest, Caterpillar Inc. objected to the Notice of Change on the ground that the Minnesota taxing scheme unconstitutionally discriminated against royalty and interest payments made by foreign members of the Caterpillar Unitary Group to Caterpillar Inc. and its domestic subsidiaries in contravention of the Foreign Commerce Clause of the U.S. Constitution. On March 24, 1995, the Department issued a Notice of Determination on Appeal, refusing to grant Caterpillar Inc. the relief requested, and making final the changes in tax. (A copy of the administrative record is attached as Joint Exhibit H-8).

H. Property, Payroll and Sales Factors of Domestic Members of the Caterpillar Group

17. The 1979-1987 property, payroll and sales of the domestic members of the Caterpillar Group are provided in Joint Exhibit C-3. [Delete Conek S.A. de C.V. and Caterpillar Mexicana S.A. de C.V. from Exhibit C-3. Add Caterpillar Export Ltd. to Exhibit C-3.]

I. Property, Payroll and Sales Factors of Foreign Members of the Caterpillar Group

18. The unaudited 1979-1987 property, payroll and sales of the foreign members of the Caterpillar Group are provided in Joint Exhibit I-9. [Add Conek S.A. de C.V. and Caterpillar Mexicana S.A. de C.V. to Exhibit I-9. Delete Caterpillar Export Ltd. from Exhibit I-9.] These remain subject to audit and adjustment by the Commissioner during and following the case. One or more of these foreign members were part of the Caterpillar Unitary Group during any or all of the tax years.

19. None of the foreign members of the Caterpillar Group had property, payroll or sales within Minnesota in any of the tax years.

J. Returns, etc.

20. Caterpillar Inc. and its other qualifying subsidiaries filed a consolidated federal income tax return for each of the calendar years 1979-1987. The Minnesota returns of Caterpillar Inc., Solar, and CFSC for the calendar years 19791987 are incorporated in this stipulation by reference.

21. True and correct copies of the 1979-1987 annual reports of Caterpillar Inc. are attached as Joint Exhibit J-10.

22. A true and correct copy of "A Code of Worldwide Business Conduct and Operating Principles" issued by Caterpillar Inc., as in effect in 1979-1987 is attached as Joint Exhibit K-11.

Respectfully submitted,

_____
Date

Jerome B. Libin
Steven M. Sobell
SUTHERLAND, ASBILL
& BRENNAN
1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-0100

Daniel J. Schlicksup
CATERPILLAR INC.
100 N.E. Adams Street
Peoria, Illinois 61629-4295
(309) 675-8039

David R. Brennan
Walter A. Pickhardt
FAEGRE & BENSON LLP
2200 Norwest Center
90 South Seventh Street
Minneapolis,
Minnesota 55402-3901
(612) 336-3000

Counsel for Caterpillar Inc.
Appellant.

HUBERT H. HUMPREY, III
Attorney General
State of Minnesota

THOMAS K. OVERTON
Assistant Attorney General
Atty. Reg. No. 83355
Tax Litigation Division
10 River Park Plaza
Mail Station 0600
St. Paul, MN 55146-0600
(612) 296-0985

Attorneys for Appellee

EXHIBIT LIST

Exhibit A-1	--	Domestic Members of the Caterpillar Group (1979 to 1987)
Exhibit B-2	--	Foreign Members of the Caterpillar Group (1979 to 1987)
Exhibit C-3	--	Property, Payroll, and Sales of the Domestic Members of the Caterpillar Group
Exhibit D-4	--	Profit or Loss Before Tax of the Domestic Members of the Caterpillar Group
Exhibit E-5	--	Profit or Loss Before Tax of the Foreign Members of the Caterpillar Group
Exhibit F-6	--	Royalty and Interest Payments Paid to Caterpillar Inc. by Domestic Members of the Caterpillar Group (1979 to 1987)
Exhibit G-7	--	Royalty and Interest Payments Paid to Caterpillar Inc. by Foreign Members of the Caterpillar Group (1979 to 1987)
Exhibit H-8	--	Administrative Record
Exhibit I-9	--	Property, Payroll, and Sales of the Foreign Members of the Caterpillar Group
Exhibit J-10	--	Annual Reports
Exhibit K-11	--	Report entitled "Code of Worldwide Business Conduct and Operating Principles"
Exhibit L-12	--	Sample License Agreement

APPENDIX D

MINNESOTA STATUTES

290.17 GROSS INCOME, ALLOCATION TO STATE

Subdivision 1. Income of resident individuals. The gross income of individuals shall be their gross income as defined in section 290.01, subdivision 20. * * *

Subd.2. Other taxpayers. In the case of an individual who is not a full-year resident, this subdivision applies to determine what income is assignable to Minnesota for purposes of determining the numerator of the fraction used in section 290.06, subdivision 2c. In the case of taxpayers not subject to the provisions of subdivision 1, items of gross income shall be assigned to this state or other states or countries in accordance with the following principles:

(1)(a) The entire income of all resident or domestic taxpayers from compensation for labor or personal services, or from a business consisting principally of the performance of personal or professional services, shall be assigned to this state, and the income of nonresident taxpayers from such sources shall be assigned to this state if, and to the extent that, the labor or services are performed within it; all other income from such sources shall be treated as income from sources without this state. * * *

(3) Income derived from carrying on a trade or business, including in the case of a business owned by natural persons the income imputable to the owner for the owner's services and the use of the owner's property therein, shall be assigned to this

state if the trade or business is conducted wholly within this state, and to other states if conducted wholly without this state. This provision shall not apply to business income subject to the provisions of clause (1).

(4) When a trade or business is carried on partly within and partly without this state, the entire income derived from such trade or business, including income from intangible property employed in such business and including, in the case of a business owned by natural persons, the income imputable to the owner for the owner's services and the use of the owner's property therein, shall be governed, except as otherwise provided in sections 290.35 and 290.36, by the provisions of section 290.19, notwithstanding any provisions of this subdivision to the contrary. This shall not apply to business income subject to the provision of clause (1), nor shall it apply to income from the operations of a farm which is subject to the provisions of clause (2). For the purposes of this clause, a trade or business located in Minnesota is carried on partly within and partly without this state if tangible personal property is sold by such trade or business and delivered or shipped to a purchaser located outside the state of Minnesota.

If the trade or business carried on wholly partly is sold by such trade or business and delivered or shipped to a purchaser located outside the state of Minnesota.

If the trade or business carried on wholly or partly in Minnesota is part of a unitary business, the entire income of that unitary business shall be subject to apportionment under section 290.19 except for business income subject to the provisions of clause (1) and farm income subject to the provisions of clause (2). The term "unitary business" shall

mean business activities or operations which are of mutual benefit, dependent upon, or contributory to one another, individually or as a group. Unity shall be presumed whenever there is unity of ownership, operation, and use, evidenced by centralized management or executive force, centralized purchasing, advertising, accounting, or other controlled interaction but the absence of these centralized activities will not necessarily evidence a nonunitary business. Unity of ownership will not be deemed to exist when a corporation is involved unless that corporation is a member of a group of two or more corporations more than 50 percent of the voting stock of each member of the group is directly or indirectly owned by a common owner or by common owners, either corporate or noncorporate, or by one or more of the member corporations of the group.

The entire income of a unitary business shall be subject to apportionment as provided in section 290.19. None of the income of a unitary business shall be considered as derived from any particular source and none shall be allocated to any particular place except as provided by the applicable apportionment formula.

In determining whether or not intangible property is employed in a unitary business carried on partly within and partly without this state so that income derived therefrom is subject to apportionment under section 290.19 the following rules and guidelines shall apply.

(a) Intangible property is employed in a business if the business entity owning intangible property holds it as a means of furthering the business operation of which a part is located within the territorial confines of this state.

(b) Where a business operation conducted in Minnesota, is owned by a business entity which carries on business activity outside of the state different in kind from that conducted within this state, and such other business is conducted entirely outside the state, it will be presumed that the two business operations are unitary in nature, interrelated, connected and interdependent unless it can be shown to the contrary. * * *

(6) All other items of gross income shall be assigned to the taxpayer's domicile.

290.19 NET INCOME; ALLOCATION TO STATE, METHODS.

Subdivision 1. **Computation, business conducted partly within state; apportionment.** The taxable net income from a trade or business carried on partly within and partly without this state shall be computed by deducting from the gross income of such business, wherever derived, deductions of the kind permitted by section 290.09, so far as connected with or allocable against the production or receipt of such income. The remaining net income shall be apportioned to Minnesota as follows:

(1) If the business consists of the mining, producing, smelting, refining, or any combination of these activities of copper and nickel ores, or of the manufacture of personal property and the sale of said property within and without the state, the remainder shall be apportioned to Minnesota on the basis of the percentage obtained by taking the arithmetical average of the following three percentages:

(a) The percentage which the sales made within this state is of the total sales wherever made;

(b) The percentage which the total tangible property, real, personal, and mixed, owned or rented, and used by the taxpayer in this state during the tax period to connection with such trade or business is of the total tangible property, real, personal, or mixed, wherever located, owned or rented and, used by the taxpayer in connection with such trade or business during the tax period; and,

(c) The percentage which the taxpayer's total payrolls paid or incurred in this state or paid in respect to labor performed in this state in connection with such trade or business is of the taxpayer's total payrolls paid or incurred in connection with such entire trade or business;

(d) The percentage of such remainder to be assigned to this state shall not be in excess of the sum of the following percentages: 70 percent of the percentage determined under clause (1)(a), 15 percent of the percentage determined under clause (1)(b), and 15 percent of the percentage determined under clause (1)(c);

(2) (a) In all other cases the remainder shall be apportioned to Minnesota on the basis of the percentage obtained by taking the arithmetical average of the following three percentages;

(1) The percentage which the sales, gross earnings, or receipts from business operations, in whole or in part, within this state bear to the total sales, gross earnings, or receipts from business operations wherever conducted;

(2) The percentage which the total tangible property, real, personal, and mixed, owned or rented, and used by the taxpayer in this state during the tax period in connection with such trade or business is of the total tangible property, real, personal, or

mixed, wherever located, owned, or rented, and used by the taxpayer in connection with such trade or business during the tax period; and

(3) The percentage which the taxpayer's total payrolls paid or incurred in this state or paid in respect to labor performed in this state in connection with such trade or business is of the taxpayer's total payrolls paid or incurred in connection with such entire trade or business;

(4) The percentage of such remainder to be assigned to this state shall not be in excess of the sum of the following percentages: 70 percent of the percentage determined under clause (2)(a)(1), 15 percent of the percentage determined under clause (2)(a)(2), and 15 percent of the percentage determined under clause (2)(a)(3);

(b) If the methods prescribed under clause (2)(a) will not properly reflect taxable net income assignable to the state, there may be used, if practicable and if such use will properly and fairly reflect such income, the percentage which the sales, gross earnings, or receipts from business operations, in whole or in part, within this state bear to the total sales, gross earnings, or receipts from business operations wherever conducted; or the separate or segregated accounting method; however, for athletic teams when the visiting team does not share in the gate receipts, all of the team's income is apportioned to the state in which the team's operation is based;

(3) If the business consists exclusively of the selling of tangible personal property and services in response to orders received by United States mail or telephone, and 100 percent of the taxpayer's property and payroll is within Minnesota, then the taxpayer may apportion net income to Minnesota as

provided in clause (1) or (2), except that the percentage applicable in clause (1)(d) or (2)(a)(4) shall be 100 percent of the percentage determined under clause (1)(a) or (2)(a)(1). In determining eligibility for this paragraph, the sale not in the ordinary course of business of tangible or intangible assets used in conducting business activities shall be disregarded.

(4) The sales, payrolls, earnings, and receipts referred to in this section shall be those for the taxable year in respect of which the tax is being computed. The property referred to in this section shall be the average of the property owned or rented and used by the taxpayer during the taxable year in respect of which the tax is being computed. For purposes of computing the property factor referred to in this section, United States government property which is used by the taxpayer shall be considered as being owned by the taxpayer.

Subd. 1a. Determination of sales made within this state. For purpose of this section the following rules shall apply in determining whether or not sales are made within this state.

Sales of tangible personal property are made within this state if the property is received by a purchaser at a point within this state, and the taxpayer is taxable in this state, regardless of the f.o.b. point, other conditions of the sale, or the ultimate destination of the properly. However, when intoxicating liquor, wine, fermented malt beverages, cigarettes, or tobacco products are sold to a purchaser who is licensed by a state or political subdivision to resell this property only within the state of ultimate destination, the sale is made in that state. Tangible personal property delivered to a common or contract carrier or foreign vessel for delivery to a purchaser in another state or

nation is a sale in that state or nation, regardless of f.o.b. point or other conditions of the sale.

Sales made by or through a corporation which is qualified as a domestic international sales corporation under section 992 of the Internal Revenue Code of 1954, as amended through December 31, 1985, shall not be considered to have been made within this state.

Subd. 2. Application of methods. The methods prescribed by subdivision 1 shall apply wherever and insofar as the business carried on within this state is an integral part of a business carried on both within and without this state.

Subd. 3. Application of sections 290.17 and 290.18. Nothing in this section shall prevent the application of sections 290.17 and 290.18 to that portion of a taxpayer's income which is not from a trade or business carried on partly within and partly without this state.

APPENDIX E

States With "Water's Edge" Taxing Schemes Similar to That Used by Minnesota

Alaska

Alaska Stat. § 43.20.073 (1997)

Arizona

Ariz. Rev. Stat. Ann. § 43-941 (1997)

Ariz. Rev. Stat. Ann. § 43-947 (1997)

California

Cal. Rev. & Tax. Code § 25110 (West 1997)

Colorado

Colo. Rev. Stat. Ann. § 39-22-303 (West 1997)

Florida

Fla. Stat. Ann. § 220.13 (West 1997)

Fla. Stat. Ann. § 220.131(West 1997)

Idaho

Idaho Code § 63-3027B (1997)

Illinois

Ill. Ann. Stat. ch. 35, para. 5/502 (Smith-Hurd 1997)

Ill. Ann. Stat. ch. 35, para. 5/1501 (Smith-Hurd 1997)

Indiana

Ind. Code Ann. § 6-5.5-5-1 (West 1997)

Ind. Code Ann. § 6-5.5-5-2 (West 1997)

Kansas

Kan. Stat. Ann. § 79-32,142 (1996)

Kan. Stat. Ann. § 79-3279 (1996)

Kentucky

Ky. Rev. Stat. Ann. § 141.200 (Baldwin 1997)

Ky. Rev. Stat. Ann. § 141.205 (Baldwin 1997)

Maine

Me. Rev. Stat. Ann. tit. 36, § 5220 (West 1997)

Me. Rev. Stat. Ann. tit. 36, § 5244 (West 1997)

Montana

Mont. Code Ann. § 15-31-322 (1996)

Nebraska

Neb. Rev. Stat. § 77-2734.05 (1996)

Neb. Rev. Stat. § 77-2734.04 (1996)

Neb. Rev. Stat. § 77-2761 (1996)

New Hampshire

N.H. Rev. Stat. Ann. § 77-A:2-b (1996)

N.H. Rev. Stat. Ann. § 77-A:6 (1996)

N.H. Rev. Stat. Ann. § 77-A:1 (1996)

New Mexico

N.M. Stat. Ann. § 7-2A-8.3 (1997)

N.M. Stat. Ann. § 7-2A-8.4 (1997)

N.M. Stat. Ann. § 7-2A-2 (1997)

North Dakota

N.D. Cent. Code § 57-38.4-02 (1997)

N.D. Cent. Code § 57-38.4-01 (1997)

Oregon

Or. Rev. Stat. § 317.705 (1997)

Or. Rev. Stat. § 317.710 (1997)

Or. Rev. Stat. § 317.715 (1997)

Utah

Utah Code Ann. § 59-7-402 (1997)

Utah Code Ann. § 59-7-101 (1997)

Virginia

Va. Code Ann. § 58.1-442 (Michie 1997)

Va. Code Ann. § 58.1-408 (Michie 1997)

APPENDIX F

THE STATE OF NEW HAMPSHIRE

MERRIMACK, SS. SUPERIOR COURT

No. 93-E-609

Caterpillar, Inc., et al.

v.

N.H. Dept. of Revenue Administration, et al.

ORDER

Before the Court are Caterpillar, Inc., et al.'s motion for summary judgment and the New Hampshire Department of Revenue Administration, et al.'s (the "Department") cross motion for summary judgment. The petitioners, Caterpillar Inc. and two of its subsidiaries, Caterpillar Financial Services Corporation and Solar Turbines Inc., object to the manner in which the Department calculated their New Hampshire Business Profits Tax, RSA chapter 77-A, for the years 1987-1989. The petitioners claim that certain provisions of this statute facially discriminate against foreign interest and royalty payments in violation of the Commerce Clause of the United States Constitution, Art. I, § 8, cl. 3. The parties have stipulated to the underlying facts and agree that their motions present only issues of Federal constitutional law.

Procedural History

In 1991, the Department conducted an audit of the petitioners' 1987, 1988, and 1989 New Hampshire tax returns.

The Department issued a Notice of Assessment, demanding additional Business Profits Tax payments. The Department ordered payment of the petitioners' apportioned share of $115,072,809, $131,765,387, and $82,417,636 of royalties and $9,270,117, $9,855,844, and 19,555,229 of interest received by Caterpillar from various foreign subsidiaries and affiliates in 1987, 1988, and 1989, respectively. The Department's demand was based on its inclusion of foreign interest and royalty payments as income and the petitioners' failure to do likewise. The petitioners filed a protest with the Department on September 20, 1991, arguing, among things, that the manner in which foreign interest and royalty payments had been taxed violated the foreign Commerce Clause of the United States Constitution. After a hearing held on February 19, 1993, the administrative hearing officer, in an order dated September 29, 1993, rejected petitioner's protest. The hearing officer declined to decide the constitutional issue based on lack of jurisdiction.

The petitioners then filed the present petition pursuant to RSA 21-J:28-b(IV), seeking de *novo* review of the Department's assessment and demand. The petitioners want this Court to declare that the method by which their Business Profits Tax was calculated for the years in question violates the foreign Commerce Clause of the United States Constitution. In the summer of 1995, the parties filed cross motions for summary judgment with supporting memoranda. On August 16, 1996, the parties filed a joint motion for interlocutory transfer without ruling pursuant to Supreme Court Rule 9. The New Hampshire Supreme Court declined interlocutory transfer on January 31, 1997. Pursuant to a March 24, 1997 scheduling order, the parties filed new cross motions for summary judgment with supporting memoranda. The Court held a

hearing on the parties' summary judgment motions on August 14, 1997.

Background

Caterpillar, Inc. is the parent of numerous domestic and foreign subsidiaries and several foreign affiliates. Caterpillar and all of its subsidiaries engage in one unitary business.[1/] Caterpillar Financial Services Corporation and Solar Turbines Incorporated, the petitioners in this case, conduct business in New Hampshire and are thus required to pay New Hampshire Business Profits Tax (RSA chapter 77-A). Each of these three corporations also does business outside New Hampshire. No state may tax income earned outside its borders. Therefore, New Hampshire's share of the income of these three corporations must be determined by means of apportionment. Container Corp. of America v. Franchise Tax Bd., 103 S.Ct. 2933 (1983).[2/]

1/ "Unitary Business, means one or more related business organizations engaged in business activity both within and without this state among which there exists a unity of ownership, operation, and use; or an interdependence in their functions," RSA 77-A:1(XIV). A unitary business group is comprised of separately incorporated entities involved in a single line of business. United States Steel Corp. v. Multistate Tax Commission, 98 S.Ct. 799, 813 (1978).

2/ "The linchpin of apportionability is the unitary business concept." Mobil Oil Corp., 100 S.Ct. at 1232. Apportionment has been generally described as a calculation of the local tax base by defining the scope of the unitary business and apportioning the total income of the business between the taxing state and the rest of the world using a formula that considers the unitary business's activities within and without the taxing state. Container Corp. of America, 103 S.Ct. at 2940. Unitary business apportionment has

(continued...)

New Hampshire has adopted the "water's edge" method, RSA 77A:1(XVI), to determine the portion of Caterpillar's unitary business income subject to tax in this state.[3] Using the water's edge method, the petitioners' New Hampshire Business Profits Tax is calculated generally in the following manner.

First, the total business income of the domestic members of the Caterpillar unitary business group is determined.[4] Next, the Department calculates the three apportionment factors of

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[2] (...continued)
been repeatedly upheld by the Federal Supreme Court. See id. "Functional integration, economies of scale, and centralization of management" typically render efforts to isolate income earned by a unitary group in a particular state futile because profitability arises from operation of the business as a whole. Mobil Oil Corporation v. Commissioner of Taxes of Vermon, 100 S.Ct. 1223, 1232 (1980).

[3] The State faces inherent difficulties in apportioning its share of the taxable income of unitary business groups operating in New Hampshire. In light of the "elusive" nature of this task, the Federal Constitution imposes no single apportionment formula on the States. Container Corp., 103 S.Ct. at 2939. No allocation method will enable the State to determine precisely the amount of income attributable to a group's New Hampshire operations, and every formula "devised involves some degree of arbitrariness." Barclays Bank v. Franchise Tax Bd. of California, 114 S.Ct. at 2268, 2272 (1994). New Hampshire's formula is intended to yield a "fair and equitable" approximation of taxable income. Pandora Indus.. Inc. v. State Dep't of Revenue Admin., 118 N.H. 891, 895 (1978).

[4] In this respect, the water's edge reporting method differs from the worldwide reporting method. Under the worldwide apportionment formula, the taxable income base is determined by combining the income of the entire unitary business group including both domestic and foreign subsidiaries. Barclays Bank v. Franchise Tax Bd. of California, 114 S.Ct. 2268, 2273 (1994).

property, payroll, and sales to determine the percent of the group's total income allowable to the State for business profits taxation. This three-factor formula is widely used by other states and has passed constitutional scrutiny. See Butler Bros., Inc.. v. McColgan, 62 S.Ct. 701 (1942).

The property factor is determined by dividing the value of the petitioners' New Hampshire real and personal property (the numerator) by the value of the real and personal property of the water's edge group (the denominator).[5/] The payroll and sales factors are determined in like fashion. The three resulting percentages are then averaged by combining them and dividing the total by three. This figure is the apportionment percentage which is multiplied by the water's edge group's total income, the sum being the amount of business profits that New Hampshire may tax. The New Hampshire tax rate is applied to determine the amount of the tax. See generally RSA 77-A:2, 3.

Interest and royalty payments by a foreign member of the unitary business to a domestic member are included in the income base. Interest and royalty payments made between members of the water's edge group are included in the income base because, although not added to the income of the payor, they are also not deducted from the income of the payee.

The income of foreign entities in a unitary group is not included in water's edge combined reporting, see RSA

[5/] If the worldwide reporting method were employed, the property, payroll, and sales apportionment factors would be determined by dividing the unitary group's New Hampshire property, payroll, and sales income by the unitary group's worldwide property, payroll, and sales income. Barclays, 114 S.Ct. at 2273.

77-A:1(XV), (XIX). The Department, therefore, does not consider the apportionment factors of the foreign entities in determining what percentage of the water's edge groups' income may be apportioned to New Hampshire for business profits taxation.

Discussion

The Commerce Clause provides that Congress may "regulate Commerce with foreign Nations, and among the several States." U.S. Const. Art. I, § 8, cl. 3. Although the Commerce Clause addresses Congress' right to regulate commerce, the Clause "has long been understood, as well, to provide protection from state legislation inimical to the national commerce [even] where Congress has not acted . . . ." Barclays Bank v. Franchise Tax Bd. of California, 114 S.Ct. 2268, 2276 (1994). State taxation of business income runs afoul of the Commerce Clause if

> the taxpayer demonstrates that the tax either (1) applies to an activity lacking a substantial nexus to the taxing State; (2) is not fairly apportioned; (3) discriminates against interstate [or foreign] commerce; or (4) is not fairly related to the services provided by the State.

Id. (citing Complete Auto Transit, Inc. v. Brady, 97 S.Ct. 1076, 1079 (1977). Tax taxing scheme must be considered in light of its actual effect and in conjunction with its other provisions. Maryland v. Louisiana, 101 S.Ct. 2114, 2134 (1981).

The petitioners base their constitutional challenge on prong three, arguing that New Hampshire's method of combining and apportioning corporate income facially discriminates against foreign commerce by treating interest and royalty payments

from foreign members of the Caterpillar unitary group less favorably than interest and royalty payments received from domestic members. Specifically, the petitioners claim that including foreign interest and royalty payments in the taxable income base of the water's edge corporations without including the property, payroll, and sales factors of the foreign entities in the denominator of the apportionment fraction discriminates against foreign commerce. The petitioners contend that such a method always results in a greater apportionment percentage to be applied to income and in higher taxes payable for foreign interest and royalty payments than for domestic interest and royalty payments.

In advancing their claim of discriminatory taxation, the petitioners rely solely on Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance, 112 S.Ct. 2365 (1992). The State responds that the Iowa taxation statute declared unconstitutional in Kraft is distinguishable from the New Hampshire tax scheme, RSA chapter 77-A.[4]

The Iowa taxation statute in Kraft called for separate or single entity reporting.

> Pursuant to single entity reporting only the values of a single business's activities within the state are reflected in the taxpayer's tax base. The taxing authority carves out from the taxpayer's overall business those activities taking place in, the property employed in, and the income derived

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[4] The respondents have attempted to distinguish Kraft, *inter alia*, on the ground that foreign dividend taxation was challenged in Kraft while the taxation of foreign royalty and interest payments is at issue in this case. The Court does not reach this issue because it distinguishes Kraft on other grounds.

> from sources within a single state to determine the income attributable to the state. The various subsidiaries of a multi-jurisdictional enterprise are viewed as separate from one another and the income of the affiliates that do not do business in the state are not considered in the income of the "single entity."

Du Pont De Nemours v. State Tax Assessor, 675 A.2d 82, 87 n. 9 (citing Hellerstein & Hellerstein, State and Local Taxation 432 (4th ed. 1978)).

In contrast, under New Hampshire's combined water's edge reporting, the tax base includes the income of all domestic members of the unitary business group, whether those corporations do business in New Hampshire or not. New Hampshire, however, apportions only part of this combined income base by applying a formula that takes into account the extent to which members of the water's edge group do business in the state. See Du Point, 675 A.2d at 87.

The Iowa single entity reporting method taxed only those members of a unitary business group actually operating within the state. Domestic subsidiaries not conducting business in Iowa were, therefore, excluded from the tax base as were foreign subsidiaries. However, dividends paid to the reporting parent corporation by domestic subsidiaries were excluded from the income base while dividends paid by foreign subsidiaries were included and thus subject to taxation. Kraft, 112 S.Ct. at 2368 n. 10. The Court found that domestic and foreign subsidiaries not doing business in Iowa were similarly situated pursuant to its single entity reporting system. Iowa could offer no satisfactory reason for taxing foreign dividends,

and not domestic dividends, where both were paid to the parent corporation by subsidiaries situated similarly under the single entity reporting method.

Kraft itself states that the outcome would have been different had Iowa employed a combined apportionment method. 112 S.Ct. at 2371 n. 23.[7] Every case considering Kraft, whether in the context of dividends or interest and royalty payments, has limited Kraft's holding to cases involving single entity reporting regimes. See Appeal of Morton Thiokol, Inc., 864 P.2d 1175 (Kan. 1993); E.I. Du Pont de Nemours & Co. v. State Tax Assessor, 675 A.2d 82 (Me. 1996); Caterpillar Financial Services Corp. v. Whitley, et al., No. 3-94-0830 (Ill. Ct. App., May 19, 1997); Caterpillar, Inc. v. Commissioner of

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[7] Kraft's footnote 23 states,

> If one were to compare the aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent. In considering claims of discriminatory taxation under the Commerce Clause however it is necessary to compare the taxpayers who are "most similarly situated." A corporation with a subsidiary doing business in Iowa is not situated similarly to a corporation with a subsidiary doing business abroad. In the former case, the Iowa operations of the subsidiary provide an independent basis for taxation not present in the case of the foreign subsidiary. A more appropriate comparison is between corporations whose subsidiaries do not do business in Iowa.

Kraft, 112 S.Ct. at 2371 (citation omitted) (emphasis added).

Revenue, No. 6633 (Minn. Tax Ct. November 14, 1996); see also Conoco, Inc. v. Taxation and Revenue Dept., 931 P.2d 730 (N.M. 1996) (holding Kraft applicable under New Mexico's single entity reporting scheme); Dart Indus. v. Clark, 657 A.2d 1062 (R.I. 1995) (holding Kraft applicable under Rhode Island's single entity reporting scheme).

In this case, unlike the situation in Kraft, the interest and royalty payments made by domestic and foreign subsidiaries are not treated differently. They are both included in the income base of the water's edge group. See Memorandum in Support of Petitioners' Motion for Summary Judgment at 15. They are subjected to the same apportionment formula and taxed at the same rate.

Any differing treatment of domestic and foreign subsidiaries as a whole results not from unconstitutional discrimination but from the fact that they simply are not similarly situated. Under the water's edge apportionment formula, all of the income of domestic subsidiaries is included in the income base. The domestic apportionment factors must be included to apportion that income. The income of foreign subsidiaries is excluded entirely from the group's income. Accordingly, their apportionment factors are also excluded.

What petitioners complain about, the lack of inclusion of the foreign subsidiaries' property, payroll, and sales factors in the denominator of the apportionment factor, is really a challenge to the water's edge method of combined reporting. As previously noted, this method of apportionment has been found constitutional and is used in many states. The only fair way to include all of the property, payroll, and sales factors of foreign subsidiaries in the apportionment denominator would be to

adopt a worldwide combination reporting regime which is not mandated nor even considered advisable by many experts.[8/]

The same issue raised by the petitioners was addressed in Caterpillar Financial Services Corp. v. Whitley, et al., No. 3-94-0830 (Ill. Ct. App., May 19, 1997), and Caterpillar, Inc. v. Commissioner of Revenue, No. 6633 (Minn. Tax Ct. November 14, 1996). The courts in both decisions rejected the arguments advanced by the petitioners. The Whitley court concluded that the Illinois water's edge method of apportionment did not facially discriminate against foreign commerce because only royalty and interest payments of foreign subsidiaries were taxed. Domestic subsidiaries, although not taxed on royalty and interest payments, were taxed on their income. The lack of "taxing symmetry" fatal to the Iowa scheme in Kraft was not present in the Illinois taxation statute. Whitley, slip op. at 15.[9/] In Caterpillar, Inc. v.

[8/] Although constitutional, the use of worldwide apportionment has generated considerable controversy. "The governments of many of our [nation's] trading partners have expressed their strong disapproval of [the worldwide] method of taxation." Barclays, 114 S.Ct. at 2283 n. 22. Numerous states have responded by restricting their worldwide apportionment methods or switching to a water's edge approach. See 1 Hellerstein and Hellerstein, State Taxation 8.16 at 8-185, 8187.

[9/] In Whitley, the Illinois Court of Appeals concurred with the Supreme Courts of Kansas and Maine, both of which, on the basis of footnote 23 in Kraft, limited the application of that case "to states that do not use a combined water's edge or domestic reporting method, but instead employ a single entity method of reporting." Whitley, slip op. at 13-15 (citing Appeal of Morton Thickol, Inc., 864 P.2d at 1186 (holding that foreign subsidiaries were not discriminated against because their total income was not subject to taxation, only dividend payments to the parent were taxed;

(continued...)

Commissioner of Revenue, No. 6633 (Minn. Tax Ct. November 14, 1996), the Minnesota Tax Court held that interest and royalty payments from foreign subsidiaries may be treated differently than the same payments from domestic subsidiaries because, as a result of the exclusion of foreign subsidiaries from water's edge combined reporting, foreign and domestic subsidiary groups were not similarly situated.

For the above reasons, the Court finds that New Hampshire water's edge method of business profits taxation does not violate the Commerce Clause of the Federal Constitution. Accordingly, the petitioners' Motion for Summary Judgment is **DENIED** and the respondents' Cross-Motion for Summary Judgment is **GRANTED**.

So ORDERED..

Date:_____

Kathleen A. McGuire
Presiding Justice

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[9] (...continued)
domestic subsidiaries, although not taxed on dividends, were taxed on their total income); DuPont, 675 A.2d at 88-89 (holding same).

APPENDIX G

IN THE CIRCUIT COURT OF THE
SECOND JUDICIAL CIRCUIT, IN AND
FOR LEON COUNTY, FLORIDA

Case No. 95-1290

CATERPILLAR INC., CATERPILLAR
AMERICAS CO., CATERPILLAR
FINANCIAL SERVICES CORP.
and SOLAR TURBINES INC.,

Plaintiffs,

v.

STATE OF FLORIDA, DEPARTMENT OF
REVENUE, and LARRY H. FUCHS, in his
official capacity as Executive Director,
Defendants.

_____/

ORDER DEFERRING RULING ON MOTION FOR SUMMARY JUDGMENT AND ALLOWING PARTIES TO SUPPLEMENT AFFIDAVITS

This matter is before the court on the petitioner's motion for summary judgment. The court has reviewed the motion and memoranda submitted by the respective parties in light of the affidavits and other records in the file. For the reasons that

follow, the court has determined that a decision should be deferred until the parties have had an opportunity to determine whether the issue in controversy can be resolved by the use of the relief provisions of Florida Statutes, Sections 220.44 and 214.73 (1987). Therefore, the court will defer ruling for a period of 60 days until such time as the parties are able to address this issue. The parties may submit supplemental affidavits and the court will consider the motion for summary judgment once again if the case is not settled.

The plaintiffs have advanced a persuasive argument that the Florida consolidated reporting method discriminates against foreign commerce by making an arbitrary distinction between domestic and foreign income. In support of this argument they rely on Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance, 112 S.Ct. 2365 (1992), a case that is difficult to distinguish. In this case as in Kraft, the system of apportionment appears to overstate foreign income in relation to the total taxable income attributable to the activities of the taxpayer in the State of Florida. The Department counters this point by arguing that interest and royalties are treated the same under Section 220.11 regardless of the source, and that dividends are subtracted from taxable income under Section 220.13(1)(b)(2)(a), regardless of the source. However, these statutes are apparently not applicable to subsidiary corporations within a unitary group. If that were the case, the plaintiffs' foreign source income would have been excluded and they would have had no reason to assert a claim in this case.

Nevertheless, the court is persuaded that the relief provisions of Section 214.73 (1987) and Section 220.44 (1987)

may cure a potential constitutional defect in the consolidated tax system. Therefore, the court has concluded that the plaintiffs should be given an opportunity to pursue these statutory relief provisions to determine whether the controversy can be resolved short of a declaration the statute is invalid. This course of action is consistent with the court's duty to uphold the validity of a state law when possible. For these reasons, the court has concluded the petitioner should be given an opportunity to pursue the relief provisions of Section 214.73 (1987) and Section 220.44 (1987). The court will defer ruling on the motion for summary judgment for a period of 60 days. If the issue is not settled, either party may submit further affidavits relating to their ability or inability to use the relief provisions.

The plaintiffs correctly pointed out that the Department is not required to grant relief from a previous tax determination. Likewise, it is clear that the court has no power to force the plaintiffs to proceed with a request for relief as a condition of its argument that the statute is unconstitutional. However, the positions the parties take on this issue is likely to affect the court's ruling on the pending motion for summary judgment. If the tax assessment discriminates against foreign commerce and if the Department makes no effort to provide relief, then the court may have a basis to conclude that the statute is unconstitutional, at least as it was applied to the plaintiffs. On the other hand if the plaintiffs elect to proceed without attempting to obtain relief from the tax they complain of in this case, the court is likely to view the uncertainty regarding the effect of the relief provisions as a basis to deny the motion for summary judgment. In that event, the issues could be

considered in a plenary hearing on the merits and the court would still have the ability to rule on the plaintiffs' claim the statute is facially unconstitutional.

DONE AND ORDERED in Chambers, Tallahassee, Leon County, Florida on May 2, 1996.

/s/ Philip J. Padovano
PHILIP J. PADOVANO
Circuit Judge

Copies to:

Jerome B. Libin, Esquire
Steven M. Sobell, Esquire
Sutherland, Asbill & Brennan
1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

Daniel J. Schlicksup, Esquire
Caterpillar Inc.
100 N.E. Adams Street
Peoria, Illinois 61629-4295

Sherwin P. Simmons, Esquire
C. Alan Lawson, Esquire
Victoria L. Weber, Esquire
Steel, Hector & Davis
215 South Monroe Street, Suite 601
Tallahassee, Florida 32301

Jeffrey M. Dikman, Assistant Attorney General
Office of the Attorney General
Department of Legal Affairs
The Capitol
Tallahassee, Florida 32399-1050

APPENDIX H

RULE 29.6 STATEMENT

The subsidiaries of petitioner other than wholly-owned subsidiaries are as follows:

Advanced Filtration System Inc.

Advanced Fuels, L.L.C.

Aishin Company

Aiwa Co. Ltd.

Akashi GS Co. Ltd.

Akira Shoji Co.

ZAO Unoc Equipment & Supply

Aquila Mining Systems Limited

Bio-Energy Partners

Caterpillar Elphinstone Pty. Ltd.

Caterpillar (HK) Limited

Caterpillar Hungary Ltd.

Caterpillar MHI Marketing Ltd.

Caterpillar Poland Limited

Caterpillar Shanghai Eng. Co.

Caterpillar Xuzhou Ltd.

Clean World Co.

CM Human Services Co. Ltd.

CM Logistics Services Co. Ltd.

CMEC Co. Ltd.

Chubu CM

Elphinstone Commercial Services Ltd.

Energy Power Systems Australia Pty. Ltd.

Energy Power Systems Png. Pty. Ltd.

EPSA Superannuation Nominees Pty. Ltd.

European Excavator Design Center GMBH & Co. KG
European Excavator Design Center Verwaltungs GMBH
FMK
G.M. Kenki Lease Co.
Hama-Rental Co.
Health Plan of Central Illinois Inc.
Higashichugoku CM
Higashikanto CM
Hindustan Powerplus Limited
Hokkaido CM
Hokken Service Co.
Hokuetsu CM
Hokuriku CM
Itoh Tekkesho Co. Ltd.
Kansai CM
KCM Construction Equipment Sales
Kinki CM
Kitakanto CM
Koshin CM
MC Forklift America Inc.
MC Forklift Asia Ptd Ltd.
MC Forklift Europe B.V.
Mine Power Australia Pty. Ltd.
Nishichugoku CM Construction Equipment Sales Ltd.
Nishikanto CM
Noil S.A.
P.T. Natra Raya
P.T. Solar Services Indonesia
Rapidparts Inc.

Rapisarda Fluid SRL
Rapisarda Industries S.r.L.
Rapisarda SPA
Rental Sanwa
Ryosey Kenpan Co., Ltd.
Sagakiko-Shokai Co., Ltd.
Sagami GS Co. Ltd.
SCM Operator Training Co.
SCM Shoji Company Ltd.
SCM System Service Co. Ltd.
Seiryo Company Ltd.
Shin Caterpillar Mitsubishi Ltd.
Shin Hokken Ltd.
Shizuoka CM
Sowa System Co.
Takuma Rental Lco.
TCM Construction Equipment Sales
Tokuden Co.
Tokyo CM Construction Equipment Sales Ltd.
Tokyo Rental Company
Tractor Engineers Limited
Turboservices SDN BHD
Unoc Equipment and Supply L.L.C.
V-Trac Holdings Ltd.
V-Trac Infrastructure Development Co.